

**Internal Revenue Service
Appeals Office**

Department of the Treasury

Employer Identification Number:

Release Number: 201645019

Release Date: 11/4/2016

Date: August 10, 2016

ORG

ADDRESS

Person to Contact:

Employee ID Number:

Tel:

Fax:

Tax Period(s) Ended:

December 31, 20XX

December 31, 20XX

December 31, 20XX

December 31, 20XX

Certified Mail

UIL: 0501.15-00

Dear

This is a final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code (the "Code") section 501(a) as an organization described in Code section 501(c)(15) for the tax periods above. Your determination letter dated October 15, 20XX is revoked.

Our adverse determination as to your exempt status was made for the following reason(s):

You are not an insurance company within the meaning of subchapter L of the Internal Revenue Code because your primary and predominant activity is not insurance. The purported insurance and/or reinsurance transactions lack economic substance.

Organizations that are not exempt under section 501 generally are required to file federal income tax returns (Form 1120, Form 1041 or Form 1120-F for foreign corporations) and pay tax, where applicable. For further instructions, forms, and information please visit www.irs.gov.

If you decide to contest this determination, you may file an action for declaratory judgment under the provisions of section 7428 of the Code in one of the following three venues: 1) United States Tax Court, 2) the United States Court of Federal Claims, or 3) the United States District Court for the District of Columbia. A petition or complaint in one of these three courts must be filed within 90 days from the date this determination letter was mailed to you. Please contact the clerk of the appropriate court for rules and the appropriate forms for filing petitions for declaratory judgment by referring to the enclosed Publication 892. You may write to the courts at the following addresses:

United States Tax Court
400 Second Street, N.W.
Washington, D.C. 20217

U.S. Court of Federal Claims
717 Madison Place, N.W.
Washington, D.C. 20439

U.S. District Court for the District of Columbia
333 Constitution Ave., N.W.
Washington, D.C. 20001

Processing of income tax returns and assessments of any taxes due will not be delayed if you file a petition for declaratory judgment under section 7428 of the Internal Revenue Code.

You may also be eligible for help from the Taxpayer Advocate Service (TAS). TAS is an independent organization within the IRS that can help protect your taxpayer rights. TAS can offer you help if your tax problem is causing a hardship, or you've tried but haven't been able to resolve your problem with the IRS. If you qualify for TAS assistance, which is always free, TAS will do everything possible to help you. Visit www.taxpayeradvocate.irs.gov or call 1-877-777-4778.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely Yours,

Appeals Team Manager

Enclosure: Publication 892

cc:



Department of the Treasury
Internal Revenue Service
Tax Exempt and Government Entities Division

Date:
March 14, 2014
Taxpayer identification number:

Form:

Tax year(s) ended:
12/31/20XX; 12/31/20XX;
12/31/20XX; 12/31/20XX
Person to contact / ID number:

Contact numbers:
Telephone:
Fax:
Manager's name / ID number:

Manager's contact number:

Response due date:

ORG
ADDRESS

Certified Mail - Return Receipt Requested

Dear

Why you are receiving this letter

Enclosed is a copy of our report of examination explaining why revocation of your organization's tax-exempt status is necessary.

What you need to do if you agree

If you agree with our findings, please sign the enclosed Form 6018-A, *Consent to Proposed Action*, and return it to the contact at the address listed above. We'll send you a final letter revoking your exempt status.

If we don't hear from you

If we don't hear from you within 30 calendar days from the date of this letter, we'll process your case based on the recommendations shown in the report of examination and this letter will become final.

Effects of revocation

In the event of revocation, you'll be required to file federal income tax returns for the tax year(s) shown above. File these returns with the contact at the address listed above within 30 calendar days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

What you need to do if you disagree with our findings

If you disagree with our position, you may request a meeting or telephone conference with the supervisor of the contact identified in the heading of this letter. You also may file a protest with the IRS Appeals office by submitting a written request to the contact person at the address listed above within 30 calendar days from the date of this letter. The Appeals office is independent of the Exempt Organizations division and resolves most disputes informally.

For your protest to be valid, it must contain certain specific information, including a statement of the facts, the applicable law and arguments in support of your position. For specific information needed for a valid protest, please refer to page one of the enclosed Publication 892, *How to Appeal an IRS Decision on Tax-Exempt Status*, and page six of the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Track Mediation referred to in Publication 3498 generally doesn't apply after we issue this letter.

If you and Appeals don't agree on some or all of the issues after your Appeals conference, or if you don't request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court after satisfying procedural and jurisdictional requirements.

You may also request that we refer this matter for technical advice as explained in Publication 892. Please contact the person identified in the heading of this letter if you're considering requesting technical advice. If we send a determination letter to you based on a technical advice memorandum issued by the Exempt Organizations Rulings and Agreements office, then no further IRS administrative appeal will be available to you.

Contacting the Taxpayer Advocate Office is a taxpayer right
You have the right to contact the office of the Taxpayer Advocate Service (TAS). **TAS is your voice at the IRS. This service helps taxpayers whose problems with the IRS are causing financial difficulties; who have tried but haven't been able to resolve their problems with the IRS; and those who believe an IRS system or procedure is not working as it should. If you believe you are eligible for TAS assistance, you can call the toll-free number 1-877-777-4778 or TTY/TDD 1-800-829-4059. For more information, go to www.irs.gov/advocate.** If you prefer, you may contact your local Taxpayer Advocate at:

Internal Revenue Service
Office of the Taxpayer Advocate

For additional information
If you have any questions, please call the contact at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Director, EO Examinations

Enclosures:
Report of Examination
Form 6018-A
Publication 892
Publication 3498

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

ISSUE:

1. Whether the contracts executed by ORG constitute contracts of insurance?
2. Whether the arrangement entered into by ORG involves the requisite element of risk distribution?
3. Whether more than half of the business of ORG during each of the taxable years under consideration is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies?
4. If ORG is not an insurance company, should its tax-exempt status under section 501(c)(15) of the Internal Revenue Code be revoked, effective January 1, 20XX?
5. Is the IRC 953(d) election valid if the taxpayer is not an insurance company?
6. Is ORG entitled to relief under IRC 7805(b)?

FACTS:

ORG ("Taxpayer") was formed and incorporated in Island, Territory on December 19, 20XX, under the provisions of the International Business Companies Act, Cap. 291. The taxpayer was formed to provide certain property and casualty insurance type services. The taxpayer is formed as a foreign captive insurance taxpayer. The taxpayer is authorized to issue 0 common shares with a \$0 par value. The taxpayer actually issued 0 shares in consideration of \$0 capital contribution.

The taxpayer is a single parent captive. Taxpayer is wholly owned by Trust, an irrevocable trust formed in City, County, State, on September 1, 20XX, by Indv-1, grantor. Indv-1 is the brother of Indv-2. Trust is located at Address, City, State Zip code. This is also the principal address of Indv-2 and Indv-3.

Indv-2, and wife, Indv-3 served as the initial trustees of Trust. Indv-2 is the 100% sole beneficiary of the trust. Over the years, the Board of Trustees was expanded to included Indv-4 and Indv-5, son and daughter of Dr. Indv-2 and Indv-3. However, Indv-3 and Indv-5 resigned as trustees in October 20XX. Currently, the trust is governed by Indv-2, and his son, Indv-4, and Indv-2, is still the sole beneficiary.

The TEGE examining agent obtained a copy of taxpayer's Form 1024 application administrative file from Rulings and Agreements in Washington D. C., on October 1, 20XX. The administrative file included a copy of the Form 1024 application, Articles of Incorporation; the IRC 953(d) election; regulatory filings; application for insurance business license and responses of Insurance Regulators; insurance underwriting diagrams; organizational owner chart; supplemental information for the Form 1024; a copy of Trust Agreement; financial information for 20XX and subsequent years; forms of credit reinsurance agreements entered

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

into by the taxpayer; and a copy of the 20XX insurance policies issued by the taxpayer. Other documents were received from CPA, CPA, in response to Information Document Requests issued by the examining agent to the CPA during the course of the current audit.

According to the Articles of Incorporation, the taxpayer is to be governed by a board of directors composed of one to seven directors. The board is actually composed of two directors, Indv-2 and Indv-3. Indv-2 served as Director, Chief Executive Officer (CEO), President, Treasurer, and Assistant Secretary. Indv-3 served as Vice President, Secretary, and Assistant Treasurer of the taxpayer.

Taxpayer filed an application for an insurance business license with Territory Financial Services Department, on November 20, 20XX. The application included a copy of the taxpayer's business plan. According to the business plan, Indv-2 and Indv-3, are also owners of CO-1 a City based marketer of specialty dermatologic creams that are sold to major drug store chains, such as Eckerd, Rite Aid, Walgreens, etc, and through the home shopping television channels. The Family also own interests in other City based businesses. The Family's ownership in CO-1 and other business interests was referred to as "Affiliated Business Interests."

The Affiliated Business Interests desired to insure certain of their property and casualty exposures, and are unwilling, or in some cases, unable to do so through the conventional insurance marketplace. The Affiliated Business Interests looked at alternative methods of arranging such insurance coverage and have found that providing such coverage through a captive insurance company offers the best method for satisfying its needs. ORG was formed to operate primarily to accomplish this objective.

The taxpayer was initially formed and created as a controlled foreign corporation. The taxpayer is not a member of a controlled group of corporations. As a controlled foreign corporation, Indv-2 Family, President, filed an IRC 953(d) election with the IRS on February 23, 20XX. The election was approved by the IRS, with an effective date of December 22, 20XX.

On March 15, 20XX, the IRS, Rulings and Agreements, in Cincinnati, received Form 1024, Application for Recognition of Exemption Under Section 501(a), filed by taxpayer seeking exemption as a small insurance company under section 501(c)(15) of the Internal Revenue Code. The application revealed that taxpayer was incorporated on December 22, 20XX. Thus, the taxpayer's initial tax year was comprised of the short year, December 22, 20XX through December 31, 20XX. The first full year of operations was 20XX. Taxpayer filed its initial Form 990 return for the tax year ended December 31, 20XX. Indv-2 Family, President, signed the Form 1024 application on February 29, 20XX. A Form 2848, Power of Attorney,

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

accompanied the application authorizing Attorney, Attorney, to represent the taxpayer during the application process. The attorney worked for a law firm in City, State.

In Part II of the Form 1024 application, taxpayer described its past, present and planned operations as follows:

(1) Underwriting select lines of property and casualty insurance coverages for business entities that are related but independently operated. Insurance risks underwritten may include, by the way of example, directors and officers liability, employment practices liability, expense reimbursement, intellectual asset property, tax liability, and other lines of property and casualty exposure. The percentage of organizational time devoted to this type of activity is estimated to be 0%-0%.

(2) Issuing reinsurance coverage for select lines of property and casualty insurance risks, i.e. serving as underwriting on certain kinds of property and casualty insurance coverages directly issued by other insurance companies, or participating in an insurance pooling arrangement with third parties. The percentage of organizational time devoted to this type of activity is estimated to be 0%-0%.

As a supporting activity to the above two primary activities, the organization will invest the monetary assets of the organization including those which are required to be held as insurance reserves to support underwriting expenses and losses. All the activities of the organization have as their purpose the carrying on of an insurance business (other than life insurance). The nature of the investments will be traditional insurance activities (see Item 2, below) which include from time to time, asset-backed loans (corporate lending) of affiliates' receivables or other assets in a commercially reasonable manner and as authorized by the insurance regulators.

The above described activities were all initiated in December 20XX. The above described activities will be conducted in the Territory through a designed, regulated and licensed insurance manager, which present time is CO-2. CO-2 is one of the larger captive managers in the Territory and is a subsidiary of an international financial services firm. CO-2 senior executives have decades of relevant insurance experience.

The largest source of financial support for the organization is income from traditional insurance underwriting activities. The only other source of

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

financial support for the organization is income from investing the organization's insurance reserves (e.g. investments in stocks, bonds, corporate lending, receivable factoring, and other investments) and related risk management activities.

On April 21, 20XX, the Form 1024 application was referred to Rulings and Agreements in Washington, D.C., for consideration and ruling. The application was assigned to a Tax Law Specialist for review on April 20XX. On April 24, 20XX, the Tax Law Specialist mailed a letter to the taxpayer's representative, Attorney, Attorney, located in City, State. The letter requested additional information about the taxpayer's operations. The taxpayer's response to the letter was originally due by May 31, 20XX. However, taxpayer's representative requested three 30 day extensions, the last extending the due date to September 30, 20XX. During the interim period, the Form 1024 application was transferred to a new Tax Law Specialist. On September 13, 20XX, the new TLS mailed a letter to taxpayer's Registered Agent in the Territory providing notification about the application transfer and to confirm the September 30, 20XX due date to the Service's request for additional information about the taxpayer's operations.

The TLS received the additional information requested from the taxpayer's representative, Attorney, Attorney, on September 25, 20XX. On October 8, 20XX, after reviewing all information exchanged between the parties, the Tax Law Specialist recommended approved of the application for tax-exempt status under section 501(c)(15) of the Internal Revenue Code. The TLS summarized the basis for approving the application as follows:

ORG was incorporated in the Territory on December 22, 20XX. ORG underwrites property and casualty insurance coverage for business entities that are related but independently operated. Insurance risks underwritten are listed in ORG's Form 1024, page 2.

Specifically, ORG writes insurance for CO-1, Indv-2 Family, M.D., P.A., and the Family Limited Partnership, none of which are owned by ORG. A Diagram of Organizational Structure and a Diagram of Insurance Underwriting Activities is shown in Exhibit D in the application case file.

ORG states that its net written premiums are not expected to exceed \$0 for any year. ORG has made an election to be treated as a domestic insurance corporation under section 953(d) of the Code.

Section 501(c)(15) of the Code provides that insurance companies or associations other than life (including interinsurer and reciprocal underwritten) are exempt from taxation under section 501(a) if net written

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

premium (or, if greater, direct written premiums) for the taxable year must not exceed \$0.

Taxpayer was granted tax-exempt status under IRC § 501(c)(15) on October 15, 20XX. The ruling was effective retroactively back to the date of incorporation, December 22, 20XX. The letter was signed by Robert C. Harper, Jr., Manager Exempt Organization, Technical Group 3. The ruling letter included the following language:

You were incorporated under the laws of the Territory. You have made an election under section 953(d) of the Code to be treated as a domestic insurance company for all purposes of the Internal Revenue Code. You are an insurance company other than life.

Based on the information supplied, and assuming your operations will be as stated in your application for recognition of exemption, we have determined you are exempt from United States income tax under section 501(a) of the Code, as an organization described in section 501(c)(15) commencing on December 22, 20XX, and for tax years when your net written premiums (or, if greater, your direct written premiums) do not exceed the \$0 limit prescribed by section 501(c)(15).

The Governor of the Territory of the Territory issued the first insurance license to taxpayer on December 22, 20XX, in accordance with the provisions of Section 17 of The Insurance of 1994. During the period of December 22, 20XX, and December 31, 20XX, taxpayer operated as a Territory corporation. Taxpayer filed Form 990 returns as an IRC 501(c)(15) small insurance company. TEGE, Exempt Organizations Division, San Francisco Post of Duty, initiated an examination of the taxpayer's 20XX Form 990 return in September 20XX.

In 20XX, the taxpayer wrote 17 direct written contracts to the Affiliated Business Interests as follows: (1) Special Risk – Collection Rate, (2) Special Risk – Expense Reimbursement, (3) Special Risk – Commercial Property GAP, (4) Special Risk – Punitive Wrap Liability, (5) Special Risk – Product Recall, (6) Special Risk – Commercial General Liability GAP, (7) Special Risk – Loss of Major Business to Business Relationship, (8) Special Risk – Medical Malpractice GAP, (9) Special Risk – Regulator Changes, (10) Special Risk – Regulatory Changes 2, (11) Special Risk – Tax Liability, (12) Special Risk – Tax Liability 2, (13) Excess Directors & Officers Liability Insurance, (14) Excess Employment Practices Liability Insurance, (15) Excess Intellectual Property Package Policy, (16) Excess Intellectual Property Package Policy 2, and (17) Excess Pollution Liability. The terms of each policy stated that the Named Insurers are ORG, as Lead Insurer, and CO-6, as a joint insurer. ORG is responsible for insuring 0% of the risks incurred under the policies and CO-6 is responsible for 0% of the risk under the policies. The contracts reviewed during the audit were sanitized by the CPA,

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

removing the names of the other Joint Insurers that assumed the remaining 0% of the direct risks.

Each of the direct written contracts issued by the taxpayer during the 20XX tax year is described below:

1. **Special Risk – Collection Rate Insurance Policy (#RATE-081)** provides the Insured against uncollectible premiums during the policy period based on the prior year's experience rate.
2. **Special Risk – Expenses Reimbursement Insurance Policy (#EXPREIM-081)** covers public relations expenses to mitigate adverse publicity to CO-1, and Indv-2 Family, M.D., P.A. under certain circumstances, including: actual or imminent incidents where the insureds potential liability amount is in excess of \$0; product recalls; layoffs and labor disputes; government or regulatory litigation; bankruptcy or other major financial crisis; loss of intellectual property rights; unsolicited takeover bids; terrorism; or any other adverse incident expected to reduce the insureds annual gross revenue by at least 0%. The policy also covers all expenses for CO-1 and Indv-2 Family, M.D., P.A.s defenses to actual or alleged civil liability.
3. **Special Risk – Commercial Property Gap Insurance Policy (#PROP-GP-081)** provides reimbursement for claims which are denied by CO-12, under Commercial Package Policy Number 70657, for the calendar year 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage caused by earthquakes, flood, or froze, from an underlying commercial property policy.
4. **Special Risk – Punitive Wrap Liability Insurance Policy (#PWRP-081)** provides that ORG will pay claims filed by the Affiliated Businesses, resulting from the failure of an insurer to cover punitive or exemplary damages, judgments, or awards, related to the other 16 policies.
5. **Special Risk – Product Recall Insurance Policy (#RECALL-081)** provides for the indemnification of the Affiliated Businesses for expenses involved in the recall of "all products manufactured and/or sold by the Affiliated Businesses during 20XX.
6. **Special Risk- Commercial General Liability Policy (#GP-081)** provides reimbursement for claims which are denied by CO-12, under General Liability Policy Number 70657, effective January 1, 20XX, through January 1, 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

7. Special Risk – Loss of Major Business to Business Relationship Insurance Policy

(#B2B-081) provides for the indemnification of CO-1 and Indv-2 Family M.D., P.A. for any business interruption loss of up to 12 months suffered as a result of losing the services. Business interruption includes the impact of lost revenue and the extra expenses involved in finding a replacement business to business relationship.

8. Special Risk – Medical Malpractice Gap Policy **(#MAL-081)** provides reimbursement for claims which are denied by the Medical Malpractice Insurance Policy; State Medical Liability Trust (" ") Policy, covering calendar year 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

9. Special Risk – Regulatory Changes Insurance Policy **(#REG-081)** covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of the Affiliated Businesses. The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by the Affiliated Businesses.

10. Special Risk – Regulatory Changes Insurance Policy **(#REG-082)** covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of the Affiliated Businesses. The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by the Affiliated Businesses.

11. Special Risk – Tax Liability Insurance Policy **(#TAX-081)** provides the Affiliated Businesses with indemnification up to 0% of the amount of additional tax liability each may incur on its 20XX federal income tax return. No coverage is provided for additions to tax, civil penalties, or criminal penalties for delinquent returns or criminal or fraudulent acts.

12. Special Risk – Tax Liability Insurance Policy **(#TAX-082)** provides the Affiliated Businesses with indemnification up to 0% of the amount of additional tax liability each may incur on its 20XX federal income tax return. No coverage is provided for additions to tax, civil penalties, or criminal penalties for delinquent returns or criminal or fraudulent acts.

13. Excess Directors & Officers Liability Insurance Policy **(#D&O-081)** provides indemnification subject to certain limitations to the Affiliated Businesses for their indemnification of its officers and directors for wrongful acts, including any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted by an officer or director of the Affiliated Businesses. The

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

policy also covers similar acts in relation to mergers and acquisitions. Moreover, the policy includes liability for pollution. The policy also provides direct and executive liability coverage for similar acts to the Affiliated Business officers and directors.

14. **Excess Employment Practices Liability Insurance Policy (#EPL-081)** provides for the indemnification of the Affiliated Businesses against all costs and expenses incurred as a result of claims filed by employees for wrongful termination, dismissal, discharge, sexual harassment, unlawful employment discrimination and employment related invasion of privacy and defamation.

15. **Excess Intellectual Property Package Policy (#IPP-081)** provides indemnification subject to certain limitations to PAE and PAP for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

16. **Excess Intellectual Property Package Policy (#IPP-082)** provides indemnification subject to certain limitations to PAE and PAP for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

17. **Excess Pollution Liability Insurance Policy (#POLL-081)** provides for the indemnification of the Affiliated Businesses against clean up cost and diminution of property value due to any pre-existing and new on-site pollution and environmental contamination.

Each direct written contract listed the Named Insured as CO-1; CO-1.; Indv-2 Family, M.D., P. A.; the Family Limited Partnership; CO-3; CO-4, and CO-5. The address of the Named Insureds is listed in the contracts as: Address, City, State Zip code. The policy period for each contract was from January 1, 20XX to January 1, 20XX.

The contracts also listed the aggregate limit of insurance and the premium paid by the total Combined Premium paid by the Named Insured as follows:

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX

Contracts	Aggregate Limit	Total Combined Premium	ORG Premiums
1. Special Risk – Collection Rate	\$ 0	\$ 0	\$ 0
2. Special Risk – Expense Reimbursement	0	0	0
3. Special Risk – Commercial Property GAP	0	0	0
4. Special Risk – Punitive Wrap Liability	0	0	0
5. Special Risk – Product Recall	0	0	0
6. Special Risk – Commercial General Liability GAP	0	0	0
7. Special Risk – Loss of Major B2B Relationship	0	0	0
8. Special Risk – Medical Malpractice GAP	0	0	0
9. Special Risk – Regulatory Changes	0	0	0
10. Special Risk – Regulatory Changes	0	0	0
11. Special Risk – Tax Liability	0	0	0
12. Special Risk – Tax Liability	0	0	0
13. Excess Directors & Officers	0	0	0
14. Excess Employment Practices	0	0	0
15. Excess Intellectual Property Package Policy	0	0	0
16. Excess Intellectual Property Package Policy	0	0	0
17. Excess Pollution Liability	0	0	0
Total	\$ 0	\$ 0	\$ 0
Direct Written Premiums, per Form 990			0
Difference			\$ 0

According to the contracts, the policy period runs from January 1, 20XX, to January 1, 20XX. A more detailed description of the policies is reflected on the attached Excel spreadsheet.

The terms of each policy state that the Named Insurers are ORG, as Lead Insurer, and CO-6 as joint insurer. ORG is responsible for insuring 0% of the risks incurred under the policies and CO-6 is responsible for 0% of the risk under the policies. The names of the remaining Joint Insurers were removed from the contracts by the taxpayer's CPA. The aggregate limits for the policies range from \$0 to \$0, with most of the policies having an aggregate limit of \$0. Combined aggregate limit is \$0. According to the terms of the contracts reviewed, ORG was to receive 0% of the combined total premiums of \$0 (or \$0) from the 17 direct written policies in 20XX. The organization reported Program Service Revenue totaling \$0 for 20XX. The 20XX Form 990-EZ return does not itemize the sources of revenue included in the program revenue amount.

Joint Underwriting Stop Loss Endorsement

In addition to the 17 direct property and casualty insurance policies, ORG also executed a Joint Underwriting Stop Loss Endorsement, with CO-6 Insurance Corp, whereby both parties agreed to underwrite the insurance coverages described in the 17 policies with the Affiliated Business Interests. ORG is identified as the "Lead Insurer." The terms of the endorsement reads as follows:

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

In exchange for the direct payment of a portion of the total policy premiums specified in the policy declarations and as further discussed below, the Insurers agree to jointly underwrite the policies specified above according to the Attachment Points, Participation Levels, and additional conditions specified herein.

The Stop Loss Insurer ("CO-6") shall have no liability for payment of any claims until two tests are met: (i) the total of all claims reported by the Insured(s) against the above policies must exceed 100% of the Combined Direct Written Premiums for all of the policies specified above; AND THEN (ii) one of the Attachment Points specified below must be reached for the policies specified above.

The agreement specifies five levels of Attachment Points that make the Stop Loss Insurer liable for claims.

Once a first Attachment Point is reached, the Stop Loss Insurer (CO-6) will be responsible for paying claims in accordance with its Participation Level detailed in paragraph 3. If another Attachment Point is subsequently reached, the subsequent Attachment Points shall be ignored and the Stop Loss Insurer's participation will be dictated by the terms of the first Attachment Point reached.

On Page 5, paragraph 4, states that the premium rate for this Joint Underwriting Stop Loss Endorsement is 0% of the combined gross direct written premiums for the specified policies due directly from the Insureds. This endorsement premium of \$0, out of the total premiums of \$0, is payable directly from the Insureds to the Stop Loss Insurer.

Based on the terms, it appears that Stop Loss Endorsement Policy serves to supplement the terms of the 17 direct written policies. Under the terms of 17 direct written contracts and the Joint Underwriting Stop Loss Endorsement agreement, the Named Insureds were required to pay of total premiums of \$0. Of the total premium, \$0 (or 0%) was paid directly to CO-6, as Stop Loss Insurer, and the balance of \$0 (or 0%) was paid directly to the taxpayer, as Joint Insurer.

In 20XX, taxpayer also entered into two reinsurance arrangements.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Quota Share Reinsurance Agreement

The first arrangement is referred to as a "reinsurance risk pooling program." ORG Ins. Corp executed a Quota Share Reinsurance Policy (#QS20XX) with CO-6. The agreement indicates that CO-6 Insurance Corp is located at Address, Island, Territory. ORG is identified as the "Reinsurer" and CO-6 Insurance Corp is the "Reinsured." The policy runs from January 1, 20XX, to January 1, 20XX.

Under this arrangement, the taxpayer participated in a "reinsurance risk pool" with several other unrelated insurance companies ("pool participants"). The risk pool was operated by CO-6. Each pool participant had one or more affiliated operating entities for which it underwrites insurance coverage, generally casualty type coverage such as credit life and credit disability. CO-6 insured a portion of the direct insurance underwritten by the pool participants using a so-called "stop loss" endorsement. CO-6 participated in over 0+ insurance policies with more than 0+ insurers. CO-6 blended together its direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. Schedule 1 attached to the policy revealed that ORG is one of many reinsurers that participated in the program and who contracted to reinsure their respective quota shares of CO-6's risk pool. According to Schedule 1, a total of 44 reinsurers are identified. CO-6 paid total premiums of \$0 to the 44 Reinsurers participating in the program. ORG is REINSURER #13.

As Reinsurer #13 the taxpayer received a Quota Share Premium from CO-6 in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued during the policy period by CO-6 Insurance Company to all stop loss endorsement policyholders. In 20XX, CO-6 Insurance Corporation paid total reinsurance premiums of \$0 to 44 participating reinsurers. Of this amount, CO-6 Insurance Corporation paid a quota share reinsurance premium of \$0, which was equal to 0% risk pool assumed by taxpayer (0% of the \$0 total premiums). According to the general ledger, the taxpayer received reinsurance premiums of \$0 from CO-6 Insurance Corp in 20XX.

The taxpayer relied on the services of CO-7 and CO-8 to establish the premium rating methodology for the direct written contracts and the Quota Share Reinsurance Agreement.

Credit Coinsurance Reinsurance Agreement

Under the terms of the second arrangement, which is referred to as the Credit Coinsurance Reinsurance Program, the taxpayer assumed reinsurance contracts from CO-6. The taxpayer reinsured a 0% quota share of the risks from vehicle service contracts reinsured by CO-6 Insurance Corporation. The vehicle service contracts were initially written by CO-9 in 20XX, assumed by CO-10, then by CO-11 from CO-10; and finally assumed by CO-6 from CO-11. The taxpayer received a pro rata share of the earned premiums received by CO-6. The taxpayer was paid a reinsurance premium of \$0 from CO-6 in 20XX.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Under the terms of the contracts reviewed for 20XX, the taxpayer assumed risk exposures as follows:

Direct Written Premiums
Quota Share Reinsurance Assumed
Other Reinsurance Assumed
Total

For the tax year ended December 31, 20XX, the taxpayer reported gross receipts of \$0 and total revenue of \$0. Revenue was derived primarily from premiums received from the direct written, reinsurance risk pooling program, and the credit coinsurance reinsurance program. The difference between gross receipts and total revenue is only the net loss from the sale of assets was reported on the Form 990 return. Gross receipts were not accurately reported on the return. The taxpayer's gross receipts for 20XX were as follows:

20XX

Program Revenue Service
Direct Written Premiums
Quota Share Reinsurance Premiums
Credit Coinsurance Reinsurance Premiums
Total Premiums
Investment Income
Proceeds from sale of assets¹
Other income
Gross Receipts

The direct written premium income was received from Indv-2 Family, M.D., P.A., and CO-1, which are owned by Indv-2, one of the beneficial owners of ORG Insurance Company, and from the Family Limited Partnership. The bank statements for the Wells Fargo checking account shows a deposit of \$0 posted to the account on December 26, 20XX. The books and records did not reveal the source of the deposit. In his April 2, 20XX response to IDR #5, CPA, CPA, identified the sources of the direct written premium deposit as follows.

CO-1	\$0
Indv-2 Family, M.D., P.A.	0
Family Family Limited Partnership	0
	<u>0</u>
\$	0

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the seventeen direct written policies with the Named Insureds, although only three of the

¹ After offsetting cost basis of \$0, the org incurred a net loss of (\$0). The net loss was reported on the return.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Named Insureds actually paid the direct written premium; 0% of the premiums are from the Quota Share Reinsurance Risk Pooling Program; and 0% of the premiums from the Credit Coinsurance Reinsurance Program.

As of December 31, 20XX, the taxpayer's assets totaled \$0, which consisted primarily of cash in temporary savings (\$0) and notes and loans receivable balances due from Affiliated Business Interests (\$0).

20XX Tax Year

The taxpayer filed Form 990, *Return of Organization Exempt From Income Tax*, for the tax year ended December 31, 20XX, claiming to be tax-exempt under IRC 501(c)(15). During the year, the taxpayer continued to operate as a captive company that insured certain property and casualty risks of affiliated business interests. However, the taxpayer participated in two of the three programs that it engaged in during the 20XX tax year: (1) direct written contracts with affiliated business interests, and (2) the credit coinsurance reinsurance programs. Taxpayer did not participate in the quota share risk pool reinsurance program in 20XX.

In addition, the direct insurance business was smaller than in 20XX. The taxpayer wrote only eight (8) of the 17 direct contracts, as written in 20XX, to insure certain property and casualty of Affiliated Business Interests. The taxpayer wrote the following 8 contracts in 20XX: Special Risk – Collection Rate; Special Risk – Commercial General Liability Gap; Excess Intellectual Property Package; Special Risk – Commercial Medical Malpractice Gap; Special Risk – Commercial Property Gap; Special Risk – Regulatory Changes; Special Risk – Tax Liability; and Special Risk – Punitive Wrap. ORG is listed as the sole Lead Insurer. CO-6 is listed the sole Stop Loss Insurer. The contracts did not list of percentage of risk assumed by the Lead and Stop Loss Insurers.

The contracts listed CO-1; CO-1.; Indv-2 Family, M.D., P. A.; Family Limited Partnership; CO-3, CO-5.; and CO-4, as the Named Insureds. The eight contracts were written for the policy period of January 1, 20XX, to January 1, 20XX.

The contracts did not list of percentage of risk assumed by the Lead and Stop Loss Insurers. However, taxpayer, as lead insurer, received 100% of the premium paid by the Named Insurers. The Named Insureds did not pay any portion of the direct written premiums to CO-6. Nor did the taxpayer disburse any portion of the direct written premiums received from the Named Insureds to CO-6. Thus, it appears that the taxpayer 100% of the risk under the terms of the direct written contracts.

Taxpayer is the sole Lead Insurer in the following direct contracts it wrote to insure certain property and casualty risks of CO-1; CO-1.; Indv-2 Family, M.D., P. A.; Family Limited

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Partnership; CO-3, CO-5.; and CO-4, for the policy period of January 1, 20XX, through January 1, 20XX:

Contracts	Aggregate Limit	Total Combined Premium	ORG Premiums
1. Special Risk – Collection Rate	\$ 0	\$ 0	\$ 0
2. Special Risk – Commercial Property GAP	0	0	0
3. Special Risk – Punitive Wrap Liability	0	0	0
4. Special Risk – Commercial General Liability GAP	0	0	0
5. Special Risk – Medical Malpractice GAP	0	0	0
6. Special Risk – Regulatory Changes	0	0	0
7. Special Risk – Tax Liability	0	0	0
8. Excess Intellectual Property Package Policy	0	0	0
Total	\$ 0	\$ 0	\$ 0
Direct Written Premiums, per Form 990			0
Difference			\$ -0-

In 20XX, taxpayer did not execute a Joint Underwriting Stop Loss Endorsement with CO-6 Insurance Corporation. Each of the direct written contracts issued by the taxpayer during the tax year is described below:

1. Special Risk – Collection Rate Insurance Policy (RATE-091) provides the Insured against uncollectible premiums during the policy period based on the prior year's experience rate.

2. Special Risk – Commercial Property Gap Insurance Policy (GP-091) provides reimbursement for claims which are denied by CO-12, under Commercial Package Policy Number 70657, for the calendar year 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage caused by earthquakes, flood, or froze, from an underlying commercial property policy.

3. Special Risk – Punitive Wrap Liability Insurance Policy (PWRP-091) provides that ORG will pay claims filed by the Affiliated Businesses, resulting from the failure of an insurer to cover punitive or exemplary damages, judgments, or awards, related to the other policies.

4. Special Risk- Commercial General Liability GP-091) provides reimbursement for claims which are denied by CO-12, under General Liability Policy Number 70657, effective January 1, 20XX, through January 1, 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

5. Special Risk – Medical Malpractice Gap Coverage (GP-091) provides reimbursement for claims which are denied by the Medical Malpractice Insurance Policy; State Medical Liability Trust (" ") Policy, covering calendar year 20XX, which includes

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

"exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

6. Special Risk – Regulatory Changes Insurance Policy (REG-091) covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of the Affiliated Businesses. The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by the Affiliated Businesses.

7. Special Risk – Tax Liability Insurance Policy TAX-091) provides the Affiliated Businesses with indemnification up to 0% of the amount of additional tax liability each may incur on its 2007 federal income tax return. No coverage is provided for additions to tax, civil penalties, or criminal penalties for delinquent returns or criminal or fraudulent acts.

8. Excess Intellectual Property Package Policy (IPP-091) provides indemnification subject to certain limitations to PAE and PAP for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

JOINT UNDERWRITING ENDORSEMENT

ORG did not execute a Joint Underwriting Stop Loss Endorsement in 20XX. Taxpayer retained 100 percent of the 20XX direct written premiums received from the Named Insureds.

QUOTA SHARE REINSURANCE POLICY

ORG did not execute a Quota Share Reinsurance contract in 20XX. Taxpayer did not receive quota share reinsurance premiums during 20XX.

CREDIT INSURANCE COINSURANCE CONTRACT

ORG executed Credit Insurance Coinsurance Contract with CO-6, a Territory Corp, in which ORG agrees to reinsure a prorate share (0%) of "all net retained policies in force on the effective date assumed by CO-6 from CO-11, an Anguilla corporation under a treaty dated June 1, 20XX with CO-11, a Island corporation that was merged into CO-11 on January 1, 20XX.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

The risks reinsured are the 20XX insurance exposures on all policies of vehicle service contracts direct written by CO-9 in force on January 1, 20XX, and subsequently issued, and assumed by CO-11, from CO-10 () Ltd., under its treaty dated January 1, 20XX.

The reinsurance premiums to be paid by CO-6 Insurance Company to ORG shall be ORG's pro rata share of the earned premiums during the accounting period under each reinsured policy. Earned premiums are the gross premiums charged the insureds plus the unearned premiums at the beginning of the Accounting Period less the unearned premiums at the end of the Accounting Period. Taxpayer received \$0 in reinsurance premiums under this contract in 20XX.

Under the terms of the contracts reviewed for 20XX, the taxpayer assumed risk exposures as follows:

Direct Written Premiums	\$	0	0%
Quota Share Reinsurance Assumed		0.00	-0-
Other Reinsurance Assumed		0	0
Total	\$	0	0%

For the tax year ended December 31, 20XX, the taxpayer reported gross receipts of \$0 and total revenue of \$0. Gross receipts were derived primarily from premiums received from the direct written and the credit coinsurance reinsurance program. The taxpayer received gross receipts as follows:

	<u>20XX</u>	
Program Revenue Service		
Direct Written Premiums	\$	0
Quota Share Reinsurance Premiums		0.00
Credit Coinsurance Reinsurance Premiums		0
Total Premiums	\$	0 0%
Investment Income		0 0
Proceeds from sale of assets ²		0 0
Other income		0 0
Gross Receipts	\$	0 100.00%

Taxpayer retained 100 percent of the 20XX direct written premiums received from the Named Insureds. The direct written premiums were deposited to a Wells Fargo Bank account (#14). In response to Question 8, IDR #1 for 20XX, the CPA provided a schedule reflecting deposits of direct written premiums to this account

²After offsetting cost basis of \$0, the org incurred a net loss of (\$0). The net loss was reported on the return.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Date of Deposit	Amount of Deposit
12/30/20XX	\$ 0
07/06/20XX	0
12/22/20XX	0
Total	\$ 0

The deposits were verified with the bank statements from the Wells Fargo Bank account (#14).

Taxpayer did not provide records showing the amount of direct written premium paid by each of the Named Insureds listed in the contracts. Thus, the examining agent was unable to determine whether the direct written premiums were paid to the taxpayer by one or all of the Named Insureds.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the eight direct written policies with the Affiliated Business Interests, 0.00% of the premiums are from the Quota Share Reinsurance Risk Pooling Program; and 0% of the premiums from the Credit Coinsurance Reinsurance Program.

As of December 31, 20XX, the taxpayer's assets totaled \$0, which consisted primarily of cash in temporary savings (\$0) and notes and loans receivable balances due from Affiliated Business Interests (\$0).

20XX Tax Year

The taxpayer filed Form 990, *Return of Organization Exempt From Income Tax*, for the tax year ended December 31, 20XX, claiming to be tax-exempt under IRC 501(c)(15). During the year, the taxpayer continued to operate as a captive company that insured certain property and casualty risks of affiliated business interests. The taxpayer participated in the same two programs that it engaged in during the 20XX tax year: (1) direct written contracts with affiliated business interests, and (2) credit coinsurance reinsurance. As in 20XX, the taxpayer did not engage in the quota share reinsurance program during 20XX.

Taxpayer's primary business continued to be that of providing property and casualty coverages for the Named Insureds, CO-1; CO-1.; Indv-2 Family, M.D., P. A.; Family Limited Partnership; CO-3, CO-5.; and CO-4

During 20XX, the taxpayer continued to operate as the sole Lead Insurer under the same 8 property and casualty contracts written to the Named Insureds, as in the 20XX tax year.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

The taxpayer wrote the following 8 contracts in 20XX: Special Risk – Collection Rate; Special Risk – Commercial General Liability Gap; Excess Intellectual Property Package; Special Risk – Commercial Medical Malpractice Gap; Special Risk – Commercial Property Gap; Special Risk – Regulatory Changes; Special Risk – Tax Liability; and Special Risk – Punitive Wrap. ORG is listed as the sole Lead Insurer. CO-6 is listed the sole Stop Loss Insurer. The contracts did not list of percentage of risk assumed by the Lead and Stop Loss Insurers.

Taxpayer is the sole Lead Insurer in the following direct contracts it wrote to insure certain property and casualty risks of CO-1; CO-1.; Indv-2 Family, M.D., P. A.; Family Limited Partnership; CO-3, CO-5.; and CO-4, for the policy period of January 1, 20XX, through January 1, 20XX:

Contracts	Aggregate Limit	Total Combined Premium	ORG Premiums
1. Special Risk – Collection Rate	\$ 0	\$ 0	\$ 0
3. Special Risk – Commercial Property GAP	0	0	0
3. Special Risk – Punitive Wrap Liability	0	0	0
4. Special Risk – Commercial General Liability GAP	0	0	0
5. Special Risk – Medical Malpractice GAP	0	0	0
6. Special Risk – Regulatory Changes	0	0	0
7. Special Risk – Tax Liability	0	0	0
8. Excess Intellectual Property Package Policy	0	0	0
Total	\$ 0	\$ 0	\$ 0
Direct Written Premiums, per Form 990			0
Difference			\$ -0-

In 20XX, taxpayer did not execute a Joint Underwriting Stop Loss Endorsement with CO-6 Insurance Corporation. Taxpayer retained 100 percent of the 20XX direct written premiums received from the Named Insureds. Each of the direct written contracts issued by the taxpayer during the tax year is described below:

1. Special Risk – Collection Rate Insurance Policy (RATE-101) provides the Insured against uncollectible premiums during the policy period based on the prior year's experience rate.

2. Special Risk – Commercial Property Gap Insurance Policy (GP-101) provides reimbursement for claims which are denied by CO-12, under Commercial Package Policy Number 70657, for the calendar year 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage caused by earthquakes, flood, or froze, from an underlying commercial property policy.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

3. Special Risk – Punitive Wrap Liability Insurance Policy (PWRP-101) provides that ORG will pay claims filed by the Affiliated Businesses, resulting from the failure of an insurer to cover punitive or exemplary damages, judgments, or awards, related to the other policies.

4. Special Risk- Commercial General Liability GAP (GP-101) provides reimbursement for claims which are denied by CO-12, under General Liability Policy Number 70657, effective January 1, 20XX, through January 1, 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

5. Special Risk – Medical Malpractice Gap Coverage (GP-101) provides reimbursement for claims which are denied by the Medical Malpractice Insurance Policy; State Medical Liability Trust (" ") Policy, covering calendar year 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

6. Special Risk – Regulatory Changes Insurance Policy (REG-101) covers actual compliance expenses and business interruptions suffered as a result of any regulatory change having an adverse impact on the normal on-going business operations of the Affiliated Businesses. The policy does not cover adverse regulatory changes resulting from substantial noncompliance with regulations or guidelines or those changes initiated in direct response to negligent acts, omissions, or errors by the Affiliated Businesses.

7. Special Risk – Tax Liability Insurance Policy (TAX-101) provides the Affiliated Businesses with indemnification up to 0% of the amount of additional tax liability each may incur on its 20XX federal income tax return. No coverage is provided for additions to tax, civil penalties, or criminal penalties for delinquent returns or criminal or fraudulent acts.

8. Excess Intellectual Property Package Policy (IPP-101) provides indemnification subject to certain limitations to PAE and PAP for all damages legally obligated to pay for litigation expenses, mitigation expenses, investigation expenses, costs to replace, restore, or re-create intellectual property, additional damages and rewards resulting from wrongful acts committed during the policy period. Wrongful acts include infringement of copyright, plagiarism, invasion or interference of right of privacy or publicity; libel; slander; piracy or unfair competition; breach of contract; patent infringement; and malicious prosecution with regard to intellectual property.

JOINT UNDERWRITING ENDORSEMENT

ORG did not execute a Joint Underwriting Stop Loss Endorsement in 20XX. Taxpayer retained 100 percent of the 20XX direct written premiums received from the Named Insureds.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

QUOTA SHARE REINSURANCE POLICY

ORG did not execute a Quota Share Reinsurance contract in 20XX. Taxpayer did not receive quota share reinsurance premiums during 20XX.

CREDIT INSURANCE COINSURANCE CONTRACT

ORG executed Credit Insurance Coinsurance Contract with CO-6, a Territory Corp, in which ORG agrees to reinsure a prorate share 0%) of "all net retained policies in force on the effective date assumed by CO-6 Insurance Company from CO-11, a Territory corporation under a treaty dated June 1, 20XX with CO-11, an Island corporation that was merged into CO-11 on January 1, 20XX.

The risks reinsured are the 20XX insurance exposures on all policies of vehicle service contracts direct written by CO-9 in force on January 1, 20XX, and subsequently issued, and assumed by CO-11, from CO-10 () Ltd., under its treaty dated January 1, 20XX.

The reinsurance premiums to be paid by CO-6 Insurance Company to ORG shall be ORG's pro rata share of the earned premiums during the accounting period under each reinsured policy. Earned premiums are the gross premiums charged the insureds plus the unearned premiums at the beginning of the Accounting Period less the unearned premiums at the end of the Accounting Period. Taxpayer received \$0 in reinsurance premiums under this contract in 20XX.

Under the terms of the contracts reviewed for 20XX, the taxpayer assumed risk exposures as follows:

Direct Written Premiums	\$	0	0%
Quota Share Reinsurance Assumed		0.00	-0-
Other Reinsurance Assumed		0	0
Total	\$	0	100.00%

For the tax year ended December 31, 20XX, the taxpayer reported gross receipts of \$0 and total revenue of \$0. Gross receipts were derived primarily from premiums received from the direct written and the credit coinsurance reinsurance program. The taxpayer received gross receipts as follows:

	<u>20XX</u>	
Program Revenue Service		
Direct Written Premiums	\$	0

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Quota Share Reinsurance Premiums	0.00	
Credit Coinsurance Reinsurance Premiums	0	
Total Premiums	\$ 0	0%
Investment Income	0	0
Proceeds from sale of assets ³	0	0
Other income	0	0
Gross Receipts	\$ 0	100.00%

Taxpayer retained 100 percent of the 20XX direct written premiums received from the Named Insureds. The direct written premiums were deposited to a Wells Fargo Bank account (#14). In response to Question 8, IDR #1 for 20XX, the CPA provided a schedule reflecting deposits of direct written premiums to this account

Date of Deposit	Amount of Deposit
12/22/20XX	\$ 0
12/29/20XX	0
12/29/20XX	0
12/31/20XX	0
Total	\$ 0

The deposits were verified with the bank statements from the Wells Fargo Bank account (#14).

Taxpayer did not provide records showing the amount of direct written premium paid by each of the Named Insureds listed in the contracts. Thus, the examining agent was unable to determine whether the direct written premiums were paid to the taxpayer by one or all of the Named Insureds.

Of the total premiums received by the taxpayer in 20XX, 0% of the premiums were generated from the eight direct written policies with the Affiliated Business Interests, 0.00% of the premiums are from the Quota Share Reinsurance Risk Pooling Program; and 0% of the premiums from the Credit Coinsurance Reinsurance Program.

As of December 31, 20XX, the taxpayer's assets totaled \$0, which consisted primarily of cash in temporary savings (\$0) and notes and loans receivable balances due from Affiliated Business Interests (\$0).

20XX

³ After offsetting cost basis of \$0, the org incurred a net loss of (\$0). The net loss was reported on the return.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Taxpayer filed Form 990 for the tax year ended December 31, 20XX. The books and records, including policies and contracts, were not examined by the examining agent as part of this audit.

Taxpayer reported gross receipts of \$0 and total revenue of \$0 for the year. Revenue was derived primarily from direct written premiums and quota share and credit coinsurance reinsurance premiums. The taxpayer received gross receipts as follows:

	<u>20XX</u>	
Program Revenue Service		
Direct Written Premiums	\$ 0	
Quota Share Reinsurance Premiums	0	
Credit Coinsurance Reinsurance Premiums	<u>0</u>	
Total Premiums	\$ 0	0%
Investment Income	0	0
Proceeds from sale of assets ⁴	0	0
Other income	<u>0</u>	<u>0</u>
Gross Receipts	\$ 0	100.00%

Under the terms of the contracts reviewed for 20XX, the taxpayer assumed risk exposures as follows:

Direct Written Premiums	\$ 0	0%
Quota Share Reinsurance	0	0
Other Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	100.00%

As of December 31, 20XX, the taxpayer's assets totaled \$0, which consisted primarily of cash in temporary savings (\$0) and notes and loans receivable balances due from Affiliated Business Interests (\$0).

LAW:

Section 501(c)(15) of the Internal Revenue Code provides insurance companies other than life (including inter-insurers and reciprocal underwriters) can qualify for tax-exempt status if:

1. The gross receipts for the taxable year do not exceed \$600,000, and more than 50% of such gross receipts consist of premiums, or

⁴After offsetting cost basis of \$0, the org incurred a net loss of (\$0). The net loss was reported on the return.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

2. In the case of a mutual insurance company, the gross receipts of which for the taxable year do not exceed \$150,000, and more than 35% of such gross receipts consist of premiums. Section 816(a) of the Code provides that the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 831(c) defines the term "insurance company" for purposes of section 831, as having the same meaning as the terms is given under section 816(a). Section 816(a) provides that the term "insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies.

Pursuant to:

Helvering v. LeGierse, 312 U.S. 531 (1941), the United States Supreme Court in defining the term "insurance contract" held that in order for a contract to amount to an insurance contract, it must shift and distribute a risk of loss and that risk must be an "insurance" risk.

AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g. 96 T.C. 18 (1991), "risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others. An arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance.

Allied Fidelity Corp. v. Commissioner, 572 F. 2d 1190, 1193 (7th Cir. 1978), the common definition for insurance is an agreement to protect the insured against a direct or indirect economic loss arising from a defined contingency whereby the insurer undertakes no present duty of performance but stands ready to assume the financial burden of any covered loss.

Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), the risk must contemplate the fortuitous occurrence of a stated contingency.

Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986), historically and commonly insurance involves risk -shifting and risk distributing. "Risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others. An arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance.

Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1153 (Fed. Cir. 1993), for insurance purposes, "risk-shifting" means one party shifts his risk of loss to another, and "risk-distributing" means that the party assuming the risk distributes his potential liability, in part, among others.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987), a true insurance agreement must remove the risk of loss from the insured party.

Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989), risk distribution involves shifting to a group of individuals the identified risk of the insured. The focus is broader and looks more to the insurer as to whether the risk insured against can be distributed over a larger group rather than the relationship between the insurer and any single insured. Revenue Ruling 89-96, 1989-2 C.B. 114, an insurance agreement or contract must involve the requisite risk shifting necessary for insurance.

Revenue Ruling 2002-89, 2002-2 C.B. 984, it is not insurance where a parent company formed a subsidiary insurance company and 90% of the subsidiary's earned premium was paid by the parent company. The Rev. Rul. further held that such arrangement between a parent and a subsidiary would constitute insurance if less than 50% of the premium earned by the subsidiary is from the parent company.

Revenue Ruling 60-275, 1960-2 C.B. 43, risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange.

Revenue Ruling 2002-90, 2002 C.B. 985, a wholly owned subsidiary that insured 12 subsidiaries of its parent constitute insurance for federal income tax purposes.

Revenue Ruling 2005-40, 2005-40 I.R.B. 4, an arrangement that purported to be an insurance contract but lacked the requisite risk distribution was characterized as a deposit arrangement, a loan, a contribution to capital, an indemnity arrangement that was not an insurance contract.

Revenue Ruling 2007-47, 2007-30 I.R.B. 127, an arrangement that provides for the reimbursement of inevitable future costs does not involve the requisite insurance risk.

Foreign Corporation Tax Provisions

IRC SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

951(a) AMOUNTS INCLUDED. —

(1) IN GENERAL. —If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends —

(A) the sum of —

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year,

(ii) his pro rata share (determined under section 955(a)(3) as in effect before the enactment of the Tax Reduction Act of 1975) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year, and

(iii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

IRC SEC. 953. INSURANCE INCOME.

953(a) INSURANCE INCOME. —

(1) IN GENERAL. —For purposes of section 952(a)(1), the term “insurance income” means any income which —

(A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and

(B) would (subject to the modifications provided by subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance company.

(2) EXCEPTION. —Such term shall not include any exempt insurance income (as defined in subsection (e)).

IRC SEC. 953. INSURANCE INCOME.

953(d) ELECTION BY FOREIGN INSURANCE COMPANY TO BE TREATED AS DOMESTIC CORPORATION.

(1) IN GENERAL. — If

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

(A) a foreign corporation is a controlled foreign corporation (as defined in section 957(a) by substituting "25 percent or more" for "more than 50 percent" and by using the definition of United States shareholder under 953(c)(1)(A)),

(B) such foreign corporation would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation,

(C) such foreign corporation meets such requirements as the Secretary shall prescribe to ensure that the taxes imposed by this chapter on such foreign corporation are paid, and

(D) such foreign corporation makes an election to have this paragraph apply and waives all benefits to such corporation granted by the United States under any treaty, for purposes of this title, such corporation shall be treated as a domestic corporation.

GOVERNMENT'S POSITION:

Qualification as Insurance Company

Neither the Internal Revenue Code nor the Income Tax Regulations define the terms "insurance" or "insurance contract." The standard for evaluating whether an arrangement constitutes insurance for federal tax purposes has evolved over the years and is, at best, a nonexclusive facts and circumstances analysis. Sears, Roebuck and Co. v. Commissioner, 972 F.2d 858, 861-64 (7th Cir. 1992). The most frequently cited opinion on the definition of insurance is Helvering v. LeGierse, 312 U.S. 531 (1941), in which the Court describes "insurance" as an arrangement involving risk-shifting and risk-distributing of an actual "insurance risk" at the time the transaction was executed. Cases analyzing "captive insurance" arrangements have described the concept of "insurance" for federal income tax purposes as containing three elements: (1) involvement of an insurance risk; (2) shifting and distributing of that risk; and (3) insurance in its commonly accepted sense. See e.g., AMERCO, Inc. v. Commissioner, 979 F.2d 162, 164-65 (9th Cir. 1992), aff'g. 96 T.C. 18 (1991). The test, however, is not a rigid three-prong test.

There is also no single definition of insurance for non-tax purposes. "[T]he subject has no useful, or fixed definition. There is neither a universally accepted definition or concept of 'insurance' nor a [sic] exclusive concept or definition that can be persuasively applied in insurance lawyering." 1 APPLEMAN ON INSURANCE 2d, § 1.3 (2005). While "it seems appropriate that any concept and meaning of insurance be sufficiently broad and flexible to meet the varying and innovative transactions which humankind perpetually produces," care must be used to describe insurance because "overbroad definitions are not useful and may

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

cause many commercial relationships erroneously to constitute insurance." Id. Moreover, a state's determination of whether a product is insurance for state law purposes does not control whether the product is insurance for federal tax law. See AMERCO, 96 T.C. 18, 41 (1991). There is no need for parity between a state law definition and federal definition as the objective for state purposes is company solvency. Solvency is not a concern for determining whether an arrangement qualifies as insurance for federal income tax purposes.

Not all contracts that transfer risk are insurance policies even where the primary purpose of the contract is to transfer risk. For example, a contract that protects against the failure to achieve a desired investment return protects against investment risk, not insurance risk. LeGierse, 312 U.S. at 542 (the risk must not be merely an investment risk); Securities and Exchange Commission v. United Benefit Life Insurance Co., 387 U.S. 202, 211 (1967) (the transfer of an investment risk cannot by itself create insurance). See also, Rev. Rul. 89-96, 1989-2 C.B. 114 (risks transferred were in the nature of investment risk, not insurance risk); Rev. Rul. 68-27, 1968-1 C.B. 315 (although an element of risk existed, it was predominantly a normal business risk of an organization engaged in furnishing medical services on a fixed price basis rather than an insurance risk) and Rev. Rul. 2007-47, 2007-2 C.B. 127 (the arrangement lacked the requisite insurance risk to constitute insurance because the arrangement lacked fortuity and the risk at issue was akin to the timing and investment risks of Rev. Rul. 89-96).

The line between investment risk and insurance risk, however, is pliable.

[t]he finance and insurance industries have much in common. The different tools these industries provide their customers for managing financial insurable risks rely on the same two fundamental concepts: risk pooling and risk transfer. Further, the valuation techniques in both financial and insurance markets are formally the same: the fair values of a security and an insurance policy are the discounted expected values of the cash flows they provide their owners. Scholars and practitioners recognize these commonalities. Not surprisingly the markets have converged recently; for example, some insurance companies offer mutual funds and life insurance tied to stock portfolios, and some banks sell annuities.

FINANCIAL ECONOMICS WITH APPLICATIONS TO INVESTMENTS,
INSURANCE AND PENSIONS 1 (Harry H. Panier, ed., 2001).

Insurance risk requires a fortuitous event or hazard and not a mere timing or investment risk. A fortuitous event⁵ (such as a fire or accident) is at the heart of any contract of insurance. See

⁵ A happening that, because it occurs only by chance or accident, the parties could not reasonably have foreseen. Black's Law Dictionary, 725 (9th ed. 2009). See also, First Restatement of Contracts § 291, cmt. a (1932); American Law

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950) (the risk must contemplate the fortuitous occurrence of a stated contingency not an expected event).

Lack of Insurance Risk

The Service analyzed the risk of the contracts to determine whether the contracts qualify as contracts of insurance, annuity contracts or reinsurance contracts. In deciding whether the contracts qualify as insurance contracts for federal tax purposes, we have considered all of the facts and circumstances associated with the parties in the context of the captive arrangement. When deciding that a specific contract is not insurance because it does not have an insurance risk but deals with a business or investment risk, we have considered such things as the ordinary activities of a business enterprise, the typical activities and obligations of running of a business, whether an action that might be covered by a policy is in the control of the insured within a business context, whether the economic risk involved is a market risk that is part of the business environment, whether the insured is required by a law or regulation to pay for the covered claim, and whether the action in question is willful or inevitable.

20XX Policies

1. Special Risk – Collection Rate Insurance Policy. (RATE-081)

Policy indemnifies for a portion of the differential between the Net Collection Percentage (NCP) during the covered period and the NCP during a baseline period. The NCP is calculated by dividing the actual collections amount during a specified period into the gross billings amount for that same period.

Not Insurance. The Policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

2. Special Risk – Expense Reimbursement Insurance Policy. (EIM-081)

Coverage Form A deals with crisis management public relations expenses. This covers all public relations expenses to mitigate the insured's adverse publicity generated from an actual or imminent: liability incident that could exceed \$0; product recall; employee layoff or labor dispute; government litigation; financial crisis; loss of intellectual property rights; unsolicited

Institute, Restatement (Second) Contracts § 379, cmt. a (1981). See Generally, Jeffery W. Stempel, Stempel on Insurance Contracts, § 1.06A[4] (2007 Supp.) ("[I]n the past 20 years, a "modern" view of fortuity as a matter of law has emerged in United States courts, one that largely embraces the notions of fortuity held by the American Law Institute when it adopted the Restatement of Contracts, first in 1932 and again in the Second Restatement published in 1981."

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

takeover bid; security incident; or any incident expected to reduce annual gross revenue by at least 0%.

Coverage Form B deals with uninsured defense. This covers all defense expense for actual or alleged civil liability where there is no insurer to provide such coverage or where such coverage has been exhausted under an existing insurance contract.

Not insurance as to Coverage A. Coverage Form A is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

Not insurance as to Coverage Form B. We could not conclude that Coverage Form B is insurance in the commonly accepted sense. It is vague as to what liability/contract underlies the need for defense expenses.

3. Special Risk – Commercial Property GAP Liability Insurance Policy (GP-081)

This policy provides “exclusion/endorsement buy back” or “differences in conditions” coverage for a Coverage Trigger from “Commercial Real Estate Package Policy, CO-13 policy pending that provide coverage during year 20XX.

Not Insurance. Terms of the contract are too vague.

4. Special Risk – Punitive Wrap Liability Insurance Policy. (PWRP-081)

Covers claims for punitive or exemplary damages upon the failure of the insurer under policies listed that are issued to the insured to cover punitive or exemplary damages, judgments, or awards solely due to the enforcement of any law or judicial ruling that precludes the insuring of punitive or similar damages and that but for such law or ruling would otherwise be covered, and for which an insured is legally obligated to pay.

Not Insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

5. Special Risk—Product Recall Insurance Policy (RECALL-081)

Not Insurance.

The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

**6. Special Risk – Commercial General Liability GAP
(GP-081)**

This policy provides coverage for certain claims which are denied by Employers Fire Insurance Company, under General Liability Policy Number 77-00, effective August 31, 20XX through August 31, 20XX, as follows: (1) Knowing Violation of Rights of Others exclusion for Personal and Advertising Injury; (2) Limitations of Coverage to Designated Events; and (3) Abuse or Molestation Exclusion.

Not Insurance. The terms of the contract are too vague.

**7. Special Risk-Loss of Major Business to Business
(B2B-081)**

Covers any business interruption loss of up to 12 months suffered as a result of losing the services of a Major Business-to-Business Relationship (any business relationship that contributes 10% or more to revenue). Business interruption losses include the impact of lost revenue and the extra expenses involved in finding a replacement Business-to-Business Relationship. The policy will not cover the voluntary loss of a Major Business-to-Business Relationship where the insured initiates the termination of the agreement; the loss of a Major Business-to-Business Relationship that insured did not attempt or intent to replace; or the loss of a Major Business-to-

Business Relationship due to insured's substantial non-compliance with the terms and conditions of its contractual agreement with the customer.

Not Insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only business risk.

**8. Special Risk – Commercial Medical Malpractice Gap Insurance Policy.
(GP-081)**

Covers claims that have been denied by the listed insurance company, which issued the underlying medical malpractice insurance policy, due to a breach of warranty, failure to notify the insurer of medical operations or procedures, sales or distribution of excluded products, or the exhaustion of the primary limits.

Not Insurance. It is vague as to what it covers.

**9. Special Risk – Regulatory Changes Insurance Policy (#081)
(REG-081)**

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Covers actual compliance expenses and any business interruption loss of up to 12 months as a result of any regulatory change that has an adverse impact on insured's normal on-going business operations. Regulatory changes include governmental, administrative agency, or legislative changes, changes to environmental, zoning, transportation, or safety laws or regulations, changes to import/export laws, regulatory changes due to foreign political risk including the collapse of a foreign economy, and any regulatory change due to the insured's reorganization, such as changing from a corporation to a limited partnership. The policy excludes any claim for an adverse regulatory change due to the insured's substantial non-compliance with regulations or other guidelines.

Not insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what it covers.

10. Special Risk – Regulatory Changes Insurance Policy (#082) (REG-082)

Covers actual compliance expenses and any business interruption loss of up to 12 months as a result of any regulatory change that has an adverse impact on insured's normal on-going business operations. Regulatory changes include governmental, administrative agency, or legislative changes, changes to environmental, zoning, transportation, or safety laws or regulations, changes to import/export laws, regulatory changes due to foreign political risk including the collapse of a foreign economy, and any regulatory change due to the insured's reorganization, such as changing from a corporation to a limited partnership. The policy excludes any claim for an adverse regulatory change due to the insured's substantial non-compliance with regulations or other guidelines.

Not insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what it covers.

11. Special Risk – Tax Liability Insurance Policy (#081) (TAX-081)

Covers any additional tax liability up to \$0 subject to a deductible equal to 0% of the actual filed IRS tax liability provided return prepared and signed by CPA. Policy also covers defense

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

expenses incurred in determining the final tax liability. Several IRS penalties are excluded from coverage.

Not insurance. The policy is not insurance in the commonly accepted sense. Although a policy only covering defense expenses is insurance, this policy also covers non-insurance risks that are investment or business risks.

12. Special Risk – Tax Liability Insurance Policy (#082)
(TAX-082)

Covers any additional tax liability up to \$0 subject to a deductible equal to 0% of the actual filed IRS tax liability provided return prepared and signed by CPA. Policy also covers defense expenses incurred in determining the final tax liability. Several IRS penalties are excluded from coverage.

Not Insurance. Although a policy only covering defense expenses is insurance, this policy also covers non-insurance risks that are investment or business risks.

13. Excess Directors & Officers Liability Insurance Policy.
(D&O-081)

Covers wrongful acts of directors and officers.

Insurance.

14. Excess Employment Practices Liability Insurance Policy.
(EPL-081)

Covers 11 categories of wrongful acts including wrongful termination, refusal to hire or promote, sexual harassment, unlawful discrimination based on age, gender, etc., invasion of privacy, failure to create employment policies or procedures, retaliatory treatment, violation of civil rights, violation of Family and Medical Leave Act, breach of employment contract, failure to provide safe work environment, violations listed herein against a non-employee. There is excluded from coverage claims related to employee's entitlements under various listed non-specific laws, rules or regulations. Also excluded are claims under various listed laws such as the Occupational Safety and Health Act. These exclusions shall not apply to claim for any actual or alleged retaliatory, discriminatory, or other employment practices-related treatment.

Not Insurance. Policy is not insurance in its commonly accepted sense. There is no insurance risk but only investment or business risk.

15. Excess Intellectual Property Package Policy (#081)
(IPP-081)

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Insuring Agreement 1 "Liability to Third Parties": Covers wrongful acts (listed above) committed by third parties against insured's intellectual property. It pays for litigation expenses, mitigation expense to mitigate the extent of the claim, costs to replace, restore, or re-create the covered intellectual property, and finally additional damages to the insured's business operations such as business interruption, loss of clients or market share, or public relation damage control efforts. The policy excludes loss due to insured's cyber presence.

Not Insurance. Insuring Agreement 1 is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risks. It is not clear what intellectual property the insured possesses.

16. Excess Intellectual Property Package Policy (#082) (IPP-082)

Insuring Agreement 2 "Loss to Your Intellectual Property": Covers damages, defense expenses, and compliance redesign expense for listed wrongful acts: infringement of copyright, trademark etc., plagiarism or unauthorized use of ideas characters, plots etc.; invasion of privacy or publicity; libel, slander, or product disparagement; piracy or unfair competition, misappropriation of advertising ideas etc.; breach of contract resulting from the alleged submission of material used by insured; patent infringement; malicious prosecution with regard to intellectual property. Compliance redesign expense covers expense to recall and/or redesign the insured's intellectual property to comply with a judgment or settlement. The policy excludes any intentional act by a director, officer or employee.

Not Insurance. Insuring Agreement 2 is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risks. It is not clear what intellectual property the insured possesses.

17. Excess Pollution Liability Insurance Policy. (POLL-081)

Insuring Agreement 1 and 2 cover clean-up costs and diminution in value costs resulting from pre-existing or new on-site pollution conditions. Coverage is conditioned on an affirmative obligation to report on site pollution conditions to a governmental agency so as to be in compliance with environmental laws. Various laws covering solid waste disposal, super funds, clean air, clean water, and toxic substances are listed in a non-exclusive list provided the insured has or may have a legal obligation to incur clean up costs for pollution conditions or pollution release. Clean up costs cover the expenses of investigation or removal of, or rendering non-hazardous pollution conditions to the extent required by environmental laws. Diminution in value means the difference in the fair market value of the property when the

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

remedial action plan is approved and the fair market value of the property had there been no on site pollution conditions.

Insuring Agreements 3 to 12 provide for third party claims for on site or off site clean up and diminution in value costs for pre-existing or new on site or off site pollution conditions, as well as bodily and property damage, as well as non-owned locations.

Insuring Agreement 13 covers pollution release from transported cargo carried by covered autos. No covered auto is identified in the declarations.

Insuring Agreement 14 covers third party claims from transporting of a product or waste.

Insuring Agreement 15 covers actual loss resulting from the interruption of the business operations caused solely and directly by on site pollution conditions. Actual loss means the net income the insured would have earned had there been no interruption. Coverage also includes loss of rental value, which generally means the anticipated rental income from tenant occupancy of insured property.

Not Insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

20XX Policies

ORG was a Joint Insurer under 8 direct contracts written by an unnamed Lead Insurer. The contracts written in 20XX were also written in 20XX. The 20XX contracts were as follows:

1. Special Risk – Collection Rate Insurance Policy (RATE-091)

Policy indemnifies for a portion of the differential between the Net Collection Percentage (NCP) during the covered period and the NCP during a baseline period. The NCP is calculated by dividing the actual collections amount during a specified period into the gross billings amount for that same period.

Not Insurance. The Policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

2. Special Risk – Commercial General Liability GAP (GP-091)

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Policy provides reimbursement for claims which are denied by CO-12, under General Liability Policy Number 70657, effective January 1, 20XX, through January 1, 20XX, which includes "exclusion/endorsement buy back" or "differences in conditions" coverage from an underlying commercial property, commercial general liability or other commercial insurance policy.

Not Insurance. The terms of the contract are too vague.

3. Excess Intellectual Property Package Policy (IPP-091)

Insuring Agreement 1: Covers damages, defense expenses, and compliance redesign expense for listed wrongful acts: infringement of copyright, trademark etc.; plagiarism or unauthorized use of ideas characters, plots etc.; invasion of privacy or publicity; libel, slander, or product disparagement; piracy or unfair competition, misappropriation of advertising ideas etc.; breach of contract resulting from the alleged submission of material used by insured; patent infringement; malicious prosecution with regard to intellectual property. Compliance redesign expense covers expense to recall and/or redesign the insured's intellectual property to comply with a judgment or settlement. The policy excludes any intentional act by a director, officer or employee.

Insuring Agreement 2: Covers wrongful acts (listed above) committed by third parties against insured's intellectual property. It pays for litigation expenses, mitigation expense to mitigate the extent of the claim, costs to replace, restore, or re-create the covered intellectual property, and finally additional damages to the insured's business operations such as business interruption, loss of clients or market share, or public relation damage control efforts. The policy excludes loss due to insured's cyber presence.

Not Insurance. Insuring Agreement 1 is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risks. It is not clear what intellectual property the insured possesses.

Insuring Agreement 2 is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risks.

4. Special Risk – Commercial Medical Malpractice Gap Insurance Policy. (GP-091)

Covers claims that have been denied by the listed insurance company, which issued the underlying medical malpractice insurance policy, due to a breach of warranty, failure to notify the insurer of medical operations or procedures, sales or distribution of excluded products, or the exhaustion of the primary limits.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Not Insurance. We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what it covers.

**5. Special Risk – Commercial Property GAP
(GP-091)**

This policy provides “exclusion/endorsement buy back” or “differences in conditions” coverage for a Coverage Trigger from “Commercial Real Estate Package Policy, CO-13 policy pending that provide coverage during calendar year 20XX.

Not Insurance. Terms of the contract are too vague.

**6. Special Risk – Regulatory Changes Insurance Policy.
(REG-091)**

Covers actual compliance expenses and any business interruption loss of up to 12 months as a result of any regulatory change that has an adverse impact on insured's normal on-going business operations. Regulatory changes include governmental, administrative agency, or legislative changes, changes to environmental, zoning, transportation, or safety laws or regulations, changes to import/export laws, regulatory changes due to foreign political risk including the collapse of a foreign economy, and any regulatory change due to the insured's reorganization, such as changing from a corporation to a limited partnership. The policy excludes any claim for an adverse regulatory change due to the insured's substantial non-compliance with regulations or other guidelines.

Not Insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

We could not conclude that this contract is insurance in the commonly accepted sense. The contract is vague as to what it covers.

**7. Special Risk – Tax Liability Insurance Policy.
(TAX-091)**

Covers any additional tax liability up to \$0 subject to a deductible equal to 0% of the actual filed IRS tax liability provided return prepared and signed by CPA. Policy also covers defense expenses incurred in determining the final tax liability. Several IRS penalties are excluded from coverage.

Not Insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

**8. Special Risk – Punitive Wrap Liability Insurance Policy.
(PWRP-091)**

Covers claims for punitive or exemplary damages upon the failure of the insurer under policies listed that are issued to the insured to cover punitive or exemplary damages, judgments, or awards solely due to the enforcement of any law or judicial ruling that precludes the insuring of punitive or similar damages and that but for such law or ruling would otherwise be covered, and for which an insured is legally obligated to pay.

Not Insurance. The policy is not insurance in the commonly accepted sense. There is no insurance risk but only investment or business risk.

20XX Policies

Wrote the same 8 polices written in 20XX. None of the direct written policies written during 20XX were deemed to be contracts of insurance.

Our review of the direct written contracts executed during the tax years under consideration is summarized as follows:

Contract	Deemed Insurance	Not Deemed Insurance
01. Special Risk-Collection Rate		No
02. Special Risk-Expense Reimbursement		No
03. Special Risk – Commercial Property GAP		No
04. Special Risk-Punitive Wrap		No
05. Special Risk – Product Recall		No
06. Special Risk – Commercial General Liability GAP		No
07. Loss of Major Business to Business		No
08. Special Risk-Commercial Medical Malpractice GAP		No
09. Special Risk-Regulatory Changes (081)		No
10. Special Risk-Regulatory Changes (082)		No
11. Special Risk-Tax Liability (081)		No
12. Special Risk-Tax Liability (082)		No
13. Excess Directors & Officers	Yes	
14. Excess Employment Practices		No
15. Excess Intellectual Property Package (081)		No
16. Excess Intellectual Property Package (082)		No

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

17. Excess Pollution

No

We were able to conclude only one of the direct written contracts as insurance contracts because they included an insurance risk. Sixteen of the Seventeen direct written contracts were deemed not to include an insurance risk and was either a business or investment risk, or we were unable to clearly identify an insurance risk.

Other Insurance Policies

Quota Share Reinsurance Program.

CO-6 participated in over 0+ insurance policies with more than 200 insureds. CO-6 blended together is direct written insurance and then reinsured the entire book on a quota share basis with each of the pool participants. As Reinsurer No. 13 in the 20XX reinsurance program, Taxpayer received a Quota Share Premium of \$0 from CO-6 in exchange for the assumption of 0% of the risk pool comprised of the stop loss coverages issued to all the stop loss endorsement policyholders (see also the Joint Underwriting Stop Loss Endorsement). ORG was not a party to the Quota Share Reinsurance Agreement during the 20XX and 20XX. ORG did not receive a Quota Share Reinsurance premium during 20XX and 20XX. ORG received a Quota Share Reinsurance premium of \$0 in 20XX.

We do not have any understanding of the risks insured by Taxpayer. We do not know whether the policies "reinsured" are similar to the several policies that we have concluded above are not insurance. However, the direct written contracts insured by CO-6 do include the 17 contracts written by ORG. Therefore, it is highly likely that the entire pool, which is insured by CO-6 and reinsured on a quota share basis with each of the pool participants, is primarily comprised of direct written contracts that the Service would deem not be insurance in the commonly accepted sense. Thus all or a portion of the premiums received by taxpayer, during the taxable years under consideration, would not be for reinsuring insurance risks.

Credit Coinsurance Reinsurance Program.

The policy reinsures risks on vehicle service contracts. Again, we do not know what risks are being insured and reinsured.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Insurance In Its Commonly Accepted Sense

Staff

As a foreign corporation, taxpayer contracted with CO-2 Trust Limited and CO-2 Insurance Management Company, in Island, Territory, to serve as its Residential Insurance Manager. Taxpayer did not hire or employ staff to conduct an insurance business. During the tax years under consideration, taxpayer did not incur salaries and wages expenses or any other payroll costs.

Pricing of Contracts

The Service also has concern about whether the premiums charged for the contracts were reasonable. A premium for an insurance contract is based on actual CO-10 calculations and factors. Even if an insurance contract is deemed to be "insurance" for federal tax purposes, the premium paid pursuant to that contract must be determined based on actual CO-10 factors and principles. In the August 23, 20XX response to IDR #1 for the 20XX and 20XX tax years, the CPA provided a copy of letters from CO-14; CO-7; and CO-8, which was purpose to address the method used for pricing the direct written and reinsurance contracts for the taxable years under consideration. However, the Service concluded that the letters did not address the method of pricing the specific direct written and reinsurance contracts that ORG was a party to during 20XX, 20XX, and 20XX. Thus, the Service concluded that the premiums received by taxpayer were not reasonable because they were not based on actual CO-10 calculations and factors.

Use of Assets

Taxpayer engaged in investment activities that are not typical of insurance companies. Based on the review of the Form 990 returns, taxpayer had four note receivable loan balances due from the Affiliated Businesses to whom it executed the direct written contracts. Loans exceeding \$0 million dollars were made to CO-1, and loans exceeding \$0 were made to a trust called Trust-2, in which the beneficiaries are Jeval affiliates. The amount of the outstanding loan receivable balances represented the total percentage of assets as follows:

	12/31/20XX	12/31/20XX	12/31/20XX	12/31/20XX
Loan balance	\$ 0	\$ 0	\$ 0	\$ 0
Total Assets	\$ 0	\$ 0	\$ 0	\$ 0
Percentage	0%	0%	0%	0%

The loans due to taxpayer from the Affiliated Businesses were still outstanding as of December 31, 20XX.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Risk Shifting

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. See Rev. Rul. 60-275 (risk shifting not present where subscribers, all subject to the same flood risk, agreed to coverage under a reciprocal flood insurance exchange).

Risk Distribution

Risk distribution incorporates the statistical phenomenon known as the law of large numbers. The concept of risk distribution "emphasizes the pooling aspect of insurance: that it is the nature of an insurance contract to be part of a larger collection of coverages, combined to distribute risks between insureds." AMERCO and Subsidiaries v. Commissioner, 96 T.C. 18, 41 (1991), aff'd, 979 F.2d 162 (9th Cir. 1992). In Treganowan, 183 F.2d at 291, the court quoting Note, The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L.J. 780, 784 (1950), explained that "by diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance." Also see Beech Aircraft Corp. v. United States, 797 F.2d 920, 922 (10th Cir. 1986), (risk distribution "means that the party assuming the risk distributes his potential liability, in part, among others"); Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135, 1135 (Fed. Cir. 1993) ("risk distribution involves spreading the risk of loss among policyholders").

Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur over time, the insurer smoothes out losses to match more closely its receipts of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

In Situation 1 of Rev. Rul. 2002-89, S, a wholly owned subsidiary of P, a domestic parent corporation, entered into an annual arrangement with P whereby S provided coverage for P's professional liability risks. The liability coverage S provided to P accounted for 90% of the total risks borne by S. Under the facts of Situation 1, the Service concluded that insurance did not exist for federal income tax purposes. On the other hand, in Situation 2 of Rev. Rul. 2002-89, the premiums that S received from the arrangement with P constituted less than 50% of total premiums received by S for the year. Under the facts of Situation 2, the Service reasoned that the premiums and risks of P were pooled with those of unrelated insureds and thus the

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

requisite risk shifting and risk distribution were present. Accordingly, under Situation 2, the arrangement between P and S constituted insurance for federal income tax purposes.

In Rev. Rul. 2002-90, S, a wholly owned insurance subsidiary of P, directly insured the professional liability risks of 12 operating subsidiaries of its parent. S was adequately capitalized and there were no related guarantees of any kind in favor of S. Most importantly, S and the insured operating subsidiaries conducted themselves in a manner consistent with the standards applicable to an insurance arrangement between unrelated parties. Together, the 12 operating subsidiaries had a significant volume of independent, homogeneous risks. Under the facts presented, the ruling concludes the arrangement between S and each of the 12 operating subsidiaries of the parent of S constitute insurance for federal income tax purposes.

Situation 1 of Rev. Rul. 2005-40, describes a scenario where a domestic corporation operated a large fleet of automotive vehicles in its courier transport business covering a large portion of the United States. This represented a significant volume of independent, homogeneous risks. For valid non-tax business purposes, the transport company entered into an insurance arrangement with an unrelated domestic corporation, whereby in exchange for an agreed amount of "premiums," the domestic carrier "insured" the transport company against the risk of loss arising out of the operation of its fleet in the conduct of its courier business. The unrelated carrier received arm's length premiums, was adequately capitalized, received no guarantees from the courier transport company and was not involved in any loans of funds back to the transport company. The transport company was the carrier's only "insured." While the requisite risk-shifting was seemingly present, the risks assumed by the carrier were not distributed among other insured's or policyholders. Therefore, the arrangement between the carrier and the transport company did not constitute insurance for federal income tax purposes.

The facts in Situation 2 of Rev. Ruling 2005-40 mirror the facts of Situation 1 except that in addition to its arrangement with the transport company, the carrier entered into a second arrangement with another unrelated domestic company. In the second arrangement, the carrier agreed that in exchange for "premiums," it would "insure" the second company against its risk of loss associated with the operation of its own transport fleet. The amount that the carrier received from the second agreement constituted 0% of the total amounts it received during the tax year on a gross and net basis. Thus, 0% of the carrier's business remained with one insured. The revenue ruling concluded that the first arrangement still lacked the requisite risk distribution to constitute insurance even though the scenario involved multiple insureds.

In Situation 4 of Rev. Rul. 2005-40, 12 LLC's elected classification as associations, each contributing between 0 and 0% of the insurer's total risks. The Service concluded that this transaction constituted insurance for federal income tax purposes.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

The principal concern with regard to your activities is whether there is sufficient risk distribution. As discussed above, the idea of risk distribution involves some mathematical concepts. For example, risk distribution is said to incorporate the statistical phenomenon known as the "law of large numbers" whereby distributing risks allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums. The concept hinges on the assumption of "numerous relatively small" and "independent risks" that "occur randomly over time." Clougherty Packing Co., 811 F.2d 1297 at 1300.

As discussed, the Service in Rev. Rul. 2002-90, concluded that insurance existed where 12 insureds each contributed between zero and 0% to the insured's total risks. Similarly, in Situation 4 of Rev. Rul. 2005-40, the Service concluded that insurance existed where 12 LLCs, electing classification as associations, each contributed between five and 15% of the insurer's total risks. Moreover, in Situation 2 of Rev. Rul. 2002-89, *supra*, the Service concluded that insurance existed where a wholly owned subsidiary insured its parent, but the arrangement represented less than 0% of the insurer's total risk for the year.

In the instance case, the facts therein are analogous to the analysis under Situation 1 of Rev. Rul. 2002-89, *supra*, the liability coverage provided to the parent corporation by its wholly owned subsidiary accounted for 0% of the total risks borne by the subsidiary. Similarly, in Situation 2 of Rev. Rul. 2005-40, *supra*, a second insurer contributing 0% of the insured's risks was added to the single-insured scenario of Situation 1. The Service concluded in both of the above scenarios that insurance did not exist because there lacked a sufficient number of insureds. The small number of insureds produced an insufficient pool of premiums to distribute any insurance risk.

With respect to the contracts reviewed during the tax years under audit, the Service concluded that the contracts between the taxpayer and CO-1 and Affiliated Businesses, the Named Insureds, do not constitute contracts of insurance because the risk transferred is a business or investment risk and not an insurance risk; and the contracts lack the essential element of risk distribution. Most of the risk insured by the taxpayer is under the direct written contracts with affiliated businesses. The affiliated businesses are indirectly owned by Indv-2, through his ownership and control of Trust, which is the 100% sole shareowner of ORG. Of total risk insured by the taxpayer, approximately 0% percent of the risk assumed during the years under audit is that of the affiliated business. Rev. Rul. 2005-40 cited several court decisions that have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. In this case, the large concentration of insurance risks in three insureds does not constitute risk distribution because of the very high likelihood of the insureds paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

In addition, of the total premiums received during the 20XX, 20XX, and 20XX tax years, 0% percent of the premiums were derived from the direct written contracts that insure the risk of the affiliated business. Approximately 0% of all premiums and 100% of the direct written premiums were paid by only three of the seven affiliated entities. Furthermore, documents reviewed during the audit revealed that three of the affiliated entities paid direct written premiums to the taxpayer in 20XX only. ORG did not write, issue or sell direct written contracts to non-affiliated business interests. Nor did the taxpayer sell direct written contracts to the general public.

During the tax years under audit, the taxpayer was primarily and predominantly supported by direct written premiums that were received from only three of the Named Insureds, CO-1, Indv-2 Family, M.D., P.A., and the Family Limited Partnership, although the contracts lists seven Named Insureds. The remaining four Named Insureds did not pay separate direct written premiums to the taxpayer during the years under consideration. The taxpayer did not receive direct written premiums from an adequate pool of insureds. Thus, the direct written contracts between the taxpayer and the Affiliated Business Interests lack the requisite risk distribution that is necessary for the contracts to be deemed contracts of insurance, as described in Subchapter L of the Internal Revenue Code.

The Service concluded that the primary and predominant activity of the taxpayer is to assume risk from contracts that are solely concentrated in seven affiliated businesses: CO-1, Ltd; CO-1.; Indv-2 Family, M.D., P.A., Family Limited Partnership; CO-3; CO-5; and CO-4. Again, although the direct written contracts list seven Named Insureds, the direct written premiums are only paid to taxpayer by CO-1, Indv-2 Family, M.D., P.A., and the Family Limited Partnership. Because the risk is too heavily concentrated in the Affiliated Business Interests, it is clear that any losses paid by the taxpayer would be those of the Affiliated Business Interests and not from an unrelated third party. In addition, since the Affiliated Business Interests paid the majority of premiums received by the taxpayer during the years under audit, the Service concluded that losses incurred by the Affiliated Business Interests were paid only from the premiums paid to the taxpayer by three of the seven Named Insureds. In other words, the arrangement between the taxpayer and the Affiliated Business Interests represents a form of self-insurance, and no court has held that self-insurance is insurance for federal tax purposes.

The Service's other concern is that over 0% of the total risks assumed by the taxpayer is with affiliated businesses that are indirectly controlled by Indv-2, beneficial owner of the taxpayer.

Because ORG did not qualify as an insurance company for federal income tax purposes, it failed to meet the requirements of section 501(c)(15) of the Code. Thus, the taxpayer did not qualify for recognition of exemption under section 501(a) of the Code as an organization

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

described in section 501(c)(15) of the Internal Revenue Code. Thus, revocation of the taxpayer's tax-exempt status under IRC 501(c)(15) is proposed, effective January 1, 20XX.

Gross Receipts Test

Section 501(c)(15) of the Internal Revenue Code provides exemptions for insurance companies, other than life insurance companies (including inter-insurers and reciprocal underwriters), if the gross receipts for the taxable year do not exceed \$600,000, and more than 50% of such gross receipts consist of premiums.

Based the Service's analysis of the contracts for 20XX, sixteen of the seventeen direct written contracts were deemed not to be insurance (or we could definitively determine whether the contract included an insurance risk). Therefore, the amounts received by ORG for those sixteen direct written contracts are not considered insurance premiums. The amount received by taxpayer for only one of the seventeen direct written contracts was deemed to be a premium because only for this single contract included an insurance risk. For 20XX and 20XX, none of the eight direct written contracts were deemed to include an insurance risk. Therefore, none of the amounts received by ORG, during 20XX and 20XX, for the direct written contracts were deemed to be premiums from insurance contracts. None of the amounts received for the direct written contracts were included as gross receipts for purposes of the gross receipts computation described in Notice 20XX-42. ORG received amounts that the Service deemed to be direct written and reinsurance premiums as follows:

	20XX	
Contract		Premium
Direct Written Contracts:		
Excess Directors & Officers Liability		
\$0 x 0%		\$ 0
Amount Deemed Premiums from Direct Written Contracts		\$ 0
Quota Share Premiums		0
Credit Coinsurance Reinsurance		0
Total Premiums for 20XX		\$ 0
Gross Receipts for 20XX		\$ 0
Percentage of Premiums to Gross Receipts		0%

	20XX	
Contract		Premium
Direct Written Contracts:		
No DW Premiums Received		\$ 0.00
Amount Deemed Premiums from Direct Written Contracts		\$ 0.00

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS	Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX

Quota Share Premiums	0.00
Credit Coinsurance Reinsurance	<u>0</u>
Total Premiums for 20XX	\$ 0
Gross Receipts for 20XX	\$ 0
Percentage of Premiums to Gross Receipts	0%

20XX

Contract	Premium
Direct Written Contracts:	
No DW Premiums Received	\$ 0.00
Amount Deemed Premiums from Direct Written Contracts	\$ 0.00
Quota Share Premiums	0.00
Credit Coinsurance Reinsurance	<u>0</u>
Total Premiums for 20XX	\$ 0
Gross Receipts for 20XX	\$ 0
Percentage of Premiums to Gross Receipts	0%

20XX

Premiums received by taxpayer for each contract in 20XX were not requested during the audit.

The amounts received by ORG under the remaining contracts were not for insurance in the commonly accepted sense. The terms of the contracts did not include insurance risk but covered investment or business risks. The remaining contracts lacked the requisite insurance risk to constitute insurance because the contracts lacked fortuity, and the risk at issue is akin to the timing and investment risks of Rev. Rul. 89-96.

An arrangement that provides for the reimbursement of believed-to-be inevitable future costs does not involve the requisite insurance risk for purposes of determining whether the assuming entity may account for the arrangement as an "insurance contract" for purposes of Subchapter L of the Internal Revenue Code. For the contracts that are deemed not to qualify as insurable risks, the amount paid for each contract, by CO-15; CO-16; and the CO-17 to the TP, do not qualify as an insurance premium.

In addition, although we question whether the Quota Share contracts are actually valid reinsurance contracts, and whether the amounts received by taxpayer under the contracts are valid reinsurance premiums, the amounts received by taxpayer from CO-6 were included as "premium income" for purposes of the gross receipts computation shown above. Even after

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

given the taxpayer the benefit of the doubt, the taxpayer still failed the gross receipts for the years under audit.

During the tax years under consideration, the premium income received by taxpayer did not exceed 50% of its gross receipts. Gross receipts were computed under Notice 20XX-42.⁶ Although gross receipts are less than the \$600,000 limitation, the amount deemed to be premiums, for each taxable year, is not more than 50% of gross receipts. Therefore, we conclude that the taxpayer did not meet the 50% gross receipts test described in IRC 501(c)(15) and Notice 20XX-42 for any tax year under audit.

As described in Situation 1 of Rev. Rul. 2002-89, supra, and Situation 2 of Rev. Rul. 2005-40, supra, there exists an inadequate premium pooling base for insurance to exist. The addition of the two other reinsurance arrangements does not change the conclusion that the contracts with the Affiliated Businesses lack the requisite risk distribution. Therefore, the taxpayer does not qualify as an insurance company.

ORG does not meet the new gross receipts test imposed by Notice 2006-42. For tax years ended December 31, 20XX, through December 31, 20XX, gross receipts did not exceed the \$600,000 limitation. However, premium income was not greater than 50% of the gross receipts generated for each year.

Application of Foreign Corporation Tax Provisions

The administrative file for the original Form 1024 application filed by ORG included a copy of the IRC 953(d) election. The election was signed by Indv-2 Family, CEO and President of ORG, on February 28, 20XX. The election was approved by IRS, National Office, commencing on December 22, 20XX. A copy of the approval IRC 953(d) election was attached to the Form 990 returns filed for the 20XX through 20XX tax years.

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify

IRC 953(d) allows foreign insurance company to elect to be treated as a domestic company for tax purposes if it meets certain requirements. One such requirement is that the foreign company must be a company that would qualify under part I or II of subchapter L for the taxable year if it were a domestic corporation. See IRC 953(d)(1)(B).

⁶ Under Notice 2006-42, only gains from the sale of capital assets are included in gross receipts.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Since the Service determined that the taxpayer is not an insurance company within the meaning of Subchapter L of the Code for the years under audit, it fails to meet the requirements for the election under IRC 953(d) to be treated as a domestic corporation.

In addition, because the company does not meet the requirements to make the IRC 953(d) election, and thus, is not a domestic corporation, the company should be treated as a "controlled foreign corporation," and the provisions of Subpart F of the Internal Revenue Code (sections 951-965) should apply. However, the Company did not generate any passive sources of income such as dividends, interest, royalties, rents or annuities, during the tax year under audit.

The subpart F provisions apply to foreign corporations that qualify as controlled foreign corporations ("CFCs"). IRC 957 defines a CFC as a foreign corporation with regard to which more than 50% of the total combined voting power of all classes of stock entitled to vote or the total value of the stock is owned by U.S. shareholders. A U.S. shareholder, in turn, is defined under IRC 951(d) as a U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Therefore, a corporation with regard to which more than 50% of the vote or value is owned by U.S. persons who individually own 10% or more or the vote will qualify as a CFC under IRC 957.

IRC 953(a)(1) defines insurance income to mean income which is attributable to the issuing or reinsuring of an insurance or annuity contract, and would be taxed under subchapter L if such income were the income of a domestic insurance company. Therefore, any premium income received by a CFC could qualify as insurance income for purposes of IRC 953 even though the CFC fails to qualify as an insurance company under subchapter L.

IRC 953(a)(2) of the Code excepts "exempt insurance income (as defined in subsection (e))" from the definition of insurance income. However, to qualify as exempt insurance income, such income must be derived by a qualifying insurance company. A qualifying insurance company is defined as a company that "is engaged in an insurance business and would be subject to tax under subchapter L if it were a domestic corporation.

IRC 953(e)(3)(C) states that income derived from U.S. sources does not qualify for exemption.

If a CFC does not qualify as an insurance company under subchapter L, it will not meet the definition of a qualifying insurance company for purposes of IRC 953(e). Thus, none of its insurance income will be exempt insurance income.

Effective Date of Revocation

An Organization may ordinarily rely on a favorable determination letter received from the Internal Revenue Service. *Regulations 1.501 (a)-1(a)(2); Rev. Proc. 2014-4, 14.01* (cross-

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

referencing 13.01 et seq.) 2014-1 C.B. 514. An Organization may not rely on a favorable determination letter, however, if the Organization omitted or misstated a material fact, in its application or in supporting documents. In addition, an Organization may not rely on a favorable determination [*43] if there is a material change, inconsistent with exemption, in the Organization's character, purposes, or methods of operation after the determination letter is issued. *Regulations 601.201(n)(3)(ii)*; *Rev. Proc. 90-27*, 13.02, 1990-1 C.B. 514.

Taxpayer filed Form 1024 with the Service on March 15, 20XX, seeking exemption under IRC 501(c)(15).

Taxpayer received a favorable ruling letter from the Service on October 15, 20XX, granting IRC 501(c)(15) tax-exempt status. Exemption was effective retroactively back to the taxpayer's date of incorporation - December 22, 20XX.

Based on the current examination, the Service proposed revocation of taxpayer's tax-exempt status under section 501(c)(15) of the Internal Revenue Code, effective January 1, 20XX. The revocation covers the tax years ended December 31, 20XX, through December 31, 20XX.

Revocation was effective as of the first day of the initial tax year under examination, when the Service determined that the taxpayer no longer met the requirements as a small insurance company under IRC 501(c)(15). As of January 1, 20XX, the Service determined that the taxpayer's primary and predominant activity was no longer insurance, and that it also failed to meet the gross receipts tests described in Notice 20XX-42 and IRC 501(c)(15)(A)(i).

TAXPAYER'S POSITION:

A response to the Preliminary Report was received from CPA, CPA, on March 10, 20XX. In the response, the CPA summarized that the taxpayer disagreed with the Service's conclusions that (1) the contracts issued by ORG lack insurance risks to constitute insurance contracts; (2) the contracts lack the requisite risk distribution; and (3) the Service ignored more than 30 years of well-established tax law, as well as the Service's hundreds of rulings.,

The CPA argued the following points:

1. All of the policies written by ORG insure against risk of loss due to fortuitous events; and there is no presence of business or investment risk coverage in any of the policies. All coverages written by ORG are for pure insurance risks.
2. The Quota Share Reinsurance contracts underwritten by ORG were contracts of insurance because all of the risks reinsured were pure insurance risks.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

3. By raising the "lack of insurance risk" issue, the Service demonstrates a clear lack of knowledge of customary insurance products as well as the insurance industry in general.
4. The CPA indicated that "in analyzing captive insurance arrangements for the presence of risk distribution, courts have looked at the level of unrelated risk as a metric for the presence of risk distribution." The Service ignored the important fact that when taking into account all the insurance policies and reinsurance contracts, all of the premiums were attributable to many thousands of independent, unrelated risks of hundreds or thousands of unrelated insureds.
5. The Service also ignored achieving distribution by issuing 28 policies to four insureds.
6. The Service ignores the Tax Court ruling in *The Harper Group and Includible Subs. v Commissioner*, 96, T.C. 45 (1991), aff'd 979 F.2d 1342 (9th Cir. 1992), where 30% unrelated risks was determined to be sufficient to meet the risk distribution requirement.
7. The CPA stated that the Service conducted no meaningful examination of risk distribution in its audit of ORG. Rather, the Service simply claims that the direct written contracts lack the requisite risk distribution. The nature of insurance is the number of underlying risk exposures present, not an artificial entity count or an artificial count of the number of policies written. The Taxpayer cites *AMERCO, Inc. v. Commissioner*, No. 91-70732, slip op. 13187 (9th Cir. Nov. 5, 1992).
8. Based on the Harper case, which held that 29% unrelated business is sufficient, and the recent Tax Court decision in *Rent-A-Center*, it is clear that the insurance and reinsurance contracts issued by ORG did not lack the requisite risk distribution. *Rent-a-Center, Inc. & Affiliated Subsidiaries v. Commissioner*, 142 T. C. 1 (2014).
9. The Service ignored Revenue Ruling 20XX-31, in which the Service conceded that it would no longer assert the economic family theory due to its rejection by the courts.
10. The CPA argues the Service's analysis of risk distribution is incomplete. The Service ignores the numerous unrelated risks that ORG insures. Courts have recognized that risk distribution can occur even with a single insured. The taxpayer cited, *Malone & Hyde v. Commissioner*.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

11. CPA argues the Service's current position is directly contrary to the position it has taken in hundreds of prior Section 501(c)(15) tax-exempt determination letters that it has issued, including the tax-exempt determination letter issued to ORG. . There has been no intervening change in law to account for the Service's disparate tax treatment between ORG and such similarly situated taxpayers. Accordingly, the Service has violated its own procedures and mandate to provide a uniform application of existing tax law (Rev. Proc. 2012-9).
12. ORG qualified for tax-exempt status as an insurance company described in IRC Section 501(c)(15) during all of the years under review. As ORG made a valid election under IRC Section 953(d) to be treated as a domestic corporation, the Service's conclusion that ORG is a controlled foreign corporation is incorrect.

Government's Response to Taxpayer's Position:

After reviewing the response to the Preliminary Report received from CPA, CPA, on March 10, 20XX, the Service's initial position is unchanged. ORG's primary and predominant business in tax years 20XX, 20XX, 20XX, and 20XX, was not insurance because the contracts issued by the company lacked insurance risks and the requisite risk distribution.

Taxpayer's Position:

In the second paragraph of the response to the agent's preliminary report, the CPA stated that the audit conclusion reached by the Service is based upon a number of unsupported and factually incorrect positions, including that ORG's insurance operations lacked the requisite insurance risk to constitute insurance and lacked the requisite risk distribution.

Government's Response:

The conclusion reached by the Service was based on an examination of the direct written and reinsurance contracts executed by ORG, and books and records for the 20XX, 20XX, and 20XX tax years. Based on the review of the contracts, the Service concluded that the primary activity of ORG was to assume risks of affiliated businesses partially owned and controlled by officers of ORG and beneficial owners of the affiliated businesses. Approximately 0% of the risk assumed by ORG was that of the affiliated businesses. ORG did not assume risk of or receive direct written premiums from non-affiliated businesses or unrelated general public under the terms of the direct written contracts. The Service concluded that the direct written contracts lack the requisite risk distribution because the arrangement did not include an adequate pool of related or unrelated insureds for the law the large numbers to operate. The pool consisted of a single policyholder and payer of direct written premiums. Thus, ORG's primary and predominant activity is not insurance as described in Subchapter L of the Internal Revenue Code.

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Taxpayer's Position:

On pages 2 and 3, the CPA described the terms of 13 direct contracts written by ORG during the tax years in question. The CPA claims that the contracts are insurance in the commonly accepted sense; the risk covered are insurance risks; and the contracts do not lack risk distribution.

Government's Position:

The government's position with respect to the status of the direct written contracts remains unchanged. The Service contends of only the Excess Directors & Officers Liability Insurance Policy covers insurance risks and thus, is a valid contract of insurance. The remaining 16 direct written contracts are not contracts of insurance in the commonly accepted sense because the contract covers business or investment risks, and not an insurance risk.

Taxpayer's Position:

On Page 4 of the Taxpayer's position, the CPA cites the *Harper Group & Subsidiaries v. Commissioner*, 96 T.C. 45(1991) to support his argument that ORG qualifies as an insurance company. The CPA cited the court's holding, when a significant percentage (29 percent) of an insurance company's income is received from a relatively large number of unrelated insureds, the requirement of risk distribution is satisfied. The source of the remaining 71 percent is irrelevant on the issue whether sufficient risk distribution is present because of the significant presence of unrelated risks.

On page 4, paragraph 2, of the response, the CPA made the following statement:

In its preliminary report, the Service merely states, that due to 70 percent of premiums being direct written premiums for coverages written to four insureds, which in fact owned no interest in ORG, there is a lack of adequate risk distribution. The Service's position ignores the fact that when taking into account all the insurance policies and reinsurance contracts, all of the premiums were attributable to many thousands or independent, unrelated risks of hundreds or thousands of unrelated insureds.

Government's Response:

The Service disagrees with the CPA's assertion that the determining factor of whether the requisite risk distribution is present is identifying the percentage of business with unrelated insureds. Instead, the current Service's position on captive insurance arrangements is expressed in Revenue Ruling 2005-40, which emphasizes the number of policyholders and percentage of business with the related or affiliated insureds as the determining factor of whether risk distribution is present. The Rev. Rul. emphasizes that an arrangement where an issuer received premiums from a single policyholder lacks the requisite risk distribution. The ruling further emphasized that an issuer with contracts with a small number of policyholders

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

can be insurance if the percentage of business exceeds 50 percent of the total insurance business conducted.

Even the CPA claim that insurance exists under the rationale in the Harper case, where approximately 30% of the risk assumed by ORG was from unrelated or unaffiliated insureds, the Service believes that this conclusion would be based on a misunderstanding of the Harper Case. In the Harper Case, 67% to 71% of the total premiums received for the years at issue were not related to a single policyholder. Rather, the 67% to 71% were the total percentages received from all related policyholders, including brother-sister corporations (a total of 13 entities). The court's analysis in Harper Group must be read in its entirety and all the facts and circumstances must be considered, i.e. that there are 13 entities making up the nearly zero risk concentration in all the years at issue.

The Service's interpretation of the Harper Group is consistent with the conclusions reached by the Service in Situation 2 of Revenue Ruling 2002-89 and Situation 4 of Revenue Ruling 2005-40.

Taxpayer's Position:

On page 5, paragraph 2, of the response, the CPA stated that the Service conducted no meaningful examination of risk distribution in its audit of ORG. Rather, the Service simply claims that the direct written contracts lack the requisite risk distribution. The nature of insurance is the number of underlying risk exposures present, not an artificial entity count or an artificial count of the number of policies written.

Government's Response:

In the March 23, 20XX response to Information Document Request #5, Question, the CPA indicated that the proper method for determining the amount of risk being assumed by the company is to compare the premiums received on the various contracts. Using the CPA's method, the taxpayer assumed risks as follows:

20XX

Direct Written Premiums	\$ 0	0%
Quota Share Reinsurance Assumed	0	0
Other Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	100.00%

20XX

Direct Written Premiums	\$ 0	0%
-------------------------	------	----

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Quota Share Reinsurance Assumed	0.00	-0-
Other Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	100.00%

20XX

Direct Written Premiums	\$ 0	0%
Quota Share Reinsurance Assumed	0.00	-0-
Other Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	100.00%

20XX

Direct Written Premiums	\$ 0	0%
Quota Share Reinsurance	0	0
Other Reinsurance Assumed	<u>0</u>	<u>0</u>
Total	\$ 0	100.00%

Under this method, the Service concluded that the taxpayer's the primary and predominant activity conducted was assuming risk under the direct written contracts with the affiliated business interests, because the activity accounted for more than 0 percent of the business (and premiums) during the years under audit.

Taxpayer's Position:

On page 6 of the response, the CPA stated that based on the recent Tax Court decision in *Rent-A-Center, Inc. & Affiliated Subsidiaries v. Commissioner*, 142 T.C. 1 (2014), it is clear that the insurance and reinsurance contracts issued by ORG did not lack requisite risk distribution.

Government's Response:

The opinion and dissent in this court case emphasized the following points:

- In 2002, the IRS likewise abandoned its position that there is a per se rule against the deductibility of brother-sister "premiums," concluding that the

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

characterization of such payments as "insurance premiums" should be governed, not by a per se rule, but by the facts and circumstances of the particular case. *Rev. Rul. 2002-90, 2002-2 C.B. 985*; accord *Rev. Rul. 20XX-31, 20XX-1 C.B. at 1348* ("The Service may continue to challenge certain captive insurance transactions based on the facts and circumstances of each case.").

- Respondent's position in the instant cases is consistent with the ruling position the IRS has maintained for the past 12 years--namely, that characterization of intragroup payments as "insurance premiums" should be determined on the basis of the facts and circumstances of the particular case.

Revenue Ruling 2005-40 describe facts and circumstances in which payments received by captives under "parent-subsidiary" and "brother-sister" arrangements would and would not qualify as an IRC 162 deduction for federal income tax purposes. *Rev. Rul. 2005-40* cited several court decisions that have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. In this case, the large concentration of insurance risks in three insureds does not constitute risk distribution because of the very high likelihood of the insureds paying for any of its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

Taxpayer's Position:

On page 6, paragraph 4, the CPA stated that in reaching its incorrect conclusion in the preliminary report, the Service appears to ignore Revenue Ruling 2001-31, in which the Service conceded that it would no longer assert the economic family theory due to its rejection by the courts.

Government's Response:

The current Service position is expressed in Ruling Revenue 2005-40, I.R.B. 2005-27 (June 17, 2005), which provides IRS issued guidance emphasizing that the requirement of risk distribution must be met. The ruling demonstrated that this risk distribution requirement cannot be satisfied if the issuer of the contract enters into such a contract with only one policyholder. If the contract fails to constitute insurance, then the premiums paid are not deductible business expenses under Code Sec. 162 and the issuing company is not an insurance company for federal tax purposes. *Rev. Rul. 2005-40* cited several court decisions that have recognized that risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. In this case, the large concentration of insurance risks in three premium paying insureds does not constitute risk distribution because of the very

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

high likelihood of the insureds paying for its claims with its own premiums. Such an arrangement is not insurance but a form of self-insurance.

However, when the arrangements between the companies do constitute insurance for federal income tax purposes and assuming these arrangements represented more than 50 percent of the insuring company's business, the company will be an insurance company within the meaning of IRC Sections 816 and 831, and the premium payments may be deductible under Code Sec. 162, assuming the requirements for deduction are otherwise satisfied.

Taxpayer's Position:

In paragraph 4, on page 7, the CPA stated that Service's current position is directly contrary to the position it has taken in hundreds of prior Section 501(c)(15) tax-exempt determination letters that it has issued, including the tax-exempt determination letter issued to ORG. There has been no intervening change in law to account for the Service's disparate tax treatment between ORG and such similarly situated taxpayers.

Government's Position:

The Service did issue a favorable ruling letter dated October 15, 20XX, granting IRC 501(c)(15) tax-exempt status to ORG. ORG relied on this favorable determination for seven years prior to the initial tax year under audit (20XX through 20XX). The Service is not precluded from revoking the ruling letter if the taxpayer did not meet the requirements for IRC 501(c)(15) tax-exempt status. Each taxpayer stands alone. The audit of the activities and books and records of ORG, and the outcome of such audit, stands alone.

Taxpayer's Position:

In the last page, paragraph 2, the CPA stated that ORG qualified for tax-exempt status as an insurance company described in IRC Section 501(c)(15) during all of the years under review. As ORG made a valid election under IRC Section 953(d) to be treated as a domestic corporation, the Service's conclusion that ORG is a controlled foreign corporation is incorrect.

Government's Response:

According to the Form 1024, Application for Recognition of Tax-Exempt Status, administrative file, the taxpayer filed its IRC 953(d) election with the Service on February 28, 20XX.

IRS records reveal that the IRC 953(d) election was approved by the Service and commenced on December 22, 20XX

IRC 953(d) allows foreign insurance company to elect to be treated as a domestic company for tax purposes if it meets certain requirements. One such requirement is that the foreign company must be a company that would qualify as an insurance company, under part I or II of subchapter L, for the taxable year if it were a domestic corporation. See IRC 953(d)(1)(B).

Form 886-A (Rev. January 1994)	EXPLANATIONS OF ITEMS		Schedule number or exhibit
Name of taxpayer	Tax Identification Number	Year/Period ended	
ORG		12/31/20XX 12/31/20XX 12/31/20XX 12/31/20XX	

Since the Service determined that the taxpayer is not an insurance company within the meaning of Subchapter L of the Code for the years under audit, it fails to meet the requirements for the election under IRC 953(d) to be treated as a domestic corporation. In addition, because the taxpayer does not meet the requirements to make the IRC 953(d) election, and thus, is not a domestic corporation, the taxpayer should be treated as a "controlled foreign corporation," and the provisions of Subpart F of the Internal Revenue Code (sections 951-965) should apply.

CONCLUSION:

Because you do not qualify as an insurance company for federal income tax purposes, you fail to meet the requirements of section 501(c)(15) of the Code. Thus, you do not qualify for recognition of exemption under section 501(a) of the Code as an organization described in section 501(c)(15) of the Internal Revenue Code. Thus, the exempt status should be revoked, effective January 1, 20XX. The revocation covers the tax years ended December 31, 20XX through December 31, 20XX.

Since the taxpayer does not qualify as an insurance company, the IRC 953(d) election filed by ORG is not valid.